Supreme Court, U.S.
FILED

01 739 NOV - 1 2001

OFFICE OF THE CLERK

No. 01-

IN THE
Supreme Court of the United States

MORGAN CAPITAL, L.L.C.,

Petitioner,

v.

MEDTOX SCIENTIFIC, INC.,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT

PETITION FOR A WRIT OF CERTIORARI

SUSAN G. KELLMAN
Counsel of Record for Petitioner
c/o STAHL & ZELMANOVITZ
767 Third Avenue
New York, New York 10017
(212) 826-6422

JOSEPH ZELMANOVITZ
Of Counsel

170303

COUNSEL PRESS
(800) 274-3321 • (800) 359-6859

10200

QUESTIONS PRESENTED

1. Whether for purposes of invoking the prohibition against short-swing profits provided by § 16(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78p(b) (the "Exchange Act"), a non-officer, non-director of an issuer that owns only preferred stock convertible into common stock based on a conversion formula equal to the lesser of a fixed rate or the average market price for the five days preceding actual conversion, can be deemed to beneficially own more than 10% of the outstanding common stock of the issuer prior to actual conversion?

2. Does the actual conversion of a person's convertible preferred stock made after a date when had the person converted he would have been the beneficial owner of more than 10% of the outstanding common stock of the issuer on that date, constitute only a change in the form of beneficial ownership and, therefore, not a separate "purchase" for purposes of § 16(b) of the Exchange Act?

3. Is a convertible security with both fixed and floating conversion price features deemed a "derivative" security under the Exchange Act so that the actual conversion of the security would not constitute a purchase under the Exchange Act and render the owner liable for a subsequent sale made within six months of the conversion?

PARTIES AND 29.6 STATEMENT

Respondent, Medtox Scientific, Inc., was formerly known as Editek, Inc.

Petitioner, Morgan Capital, LLC, has no parent corporation and no publicly held company owns 10% or more of its stock.

TABLE OF CONTENTS

	Page
Questions Presented	i
Parties and 29.6 Statement	ii
Table of Contents	iii
Table of Cited Authorities	v
Table of Appendices	ix
Opinions Below	1
Statement of Jurisdiction	2
Statutes and Rules Involved	2
Statement of the Case	2
A. The Facts	3
B. The First District Court Opinion	4
C. The First Eighth Circuit Opinion	5
D. The Second District Court Opinion	6
E. The Second Eighth Circuit Opinion	7

Contents

	Page
Reasons for Granting the Writ	8
I. The Eighth Circuit's Opinion Would Severely Restrict The Use Of Convertible Securities And Generate Confusion In The Securities Markets. The Issue Of Insider Trading Status For Convertible Securities Should Be Settled By This Court.	8
II. The Eighth Circuit's Novel Hypothetical Conversion Rule For Convertible Securities Presents A Conflict Among The Courts With Respect To Potential Liability Under Section 16(b) Of The Exchange Act.	12
A. The Eighth Circuit's Holding Conflicts With The Governing Regulations And Case Law	13
B. By Ignoring Both The Floating-Price And Fixed-Price Features Of The Medtox Convertible Preferred, The Eighth Circuit's Holding Conflicts With Decisions Of Other Courts	15
Conclusion	21

TABLE OF CITED AUTHORITIES

Page

Cases:

Allen v. Westpoint-Pepperell, Inc., Nos. 90 Civ. 3841, 89 Civ. 2016, 1996 WL 2004 (S.D.N.Y., Jan. 6, 1996) 13, 14

Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc., 467 U.S. 837, 104 S. Ct. 2778 (1984) 17

Editek, Inc. v. Morgan Capital, L.L.C., 150 F.3d 830 (8th Cir. 1998) 1

Europe & Overseas Commodity Traders, S.A. v. Banque Paribas Global Bond Futures Fund, 147 F.3d 118 (2d Cir. 1998), *cert. denied*, 525 U.S. 1139 (1999) 17

Foremost-McKesson v. Provident Secs. Co., 423 U.S. 232, 96 S. Ct. 508, 46 L. Ed. 2d 464 (1976) ... 4

GAF Corp. v. Milstein, 453 F.2d 709 (2d Cir. 1971), *cert. denied*, 406 U.S. 910 (1972) 11

General Aircraft Corp. v. Lampert, 556 F.2d 90 (1st Cir. 1977) 11

Gwozdzinsky v. Zell/Chilmark Fund, L.P., 156 F.3d 305 (2d Cir. 1998) 11, 12

Cited Authorities

Page

Lerner v. Millenco, L.P., 23 F. Supp. 2d 337 (S.D.N.Y. 1998) 16, 19

Levner v. Prince Alwaleed Bin Abdulaziz Al Saud, 903 F. Supp. 452 (S.D.N.Y. 1994), *aff'd*, 61 F.3d 8 (2d Cir. 1995) 12, 14

Levy v. Clearwater Fund IV, Ltd., 2000 U.S. Dist. LEXIS 1305, No. Civ. A. 99-004-SLR (D. Del. Feb. 2, 2000) 19

Levy v. Marshall Capital Management, Inc., Fed. Sec. L. Rep. (CCH) par. 91,230 (E.D.N.Y., July 28, 2000) 12

Levy v. Oz Master Fund, Ltd., 00 Civ. 7148 (AGS), 2001 U.S. Dist. LEXIS 9251 (S.D.N.Y. July 9, 2001) 18, 19

Levy v. Southbrook International Investments, Ltd., Fed. Sec. L. Rep. (CCH) par. 90,981 (S.D.N.Y., May 10, 2000) 12

Transcon Lines v. A.G. Becker, 470 F. Supp. 356 (S.D.N.Y. 1979) 14

United States v. Byrum, 408 U.S. 125, 92 S. Ct. 2382 (1972) 13

Cited Authorities

Page

Statutes:

15 U.S.C. § 78aa, Securities Exchange Act § 27 .. 6

15 U.S.C. § 78m(d), Securities Exchange Act § 13(d) 4, 5, 6, 9, 11, 13, 14

15 U.S.C. 78p, Securities Exchange Act § 16 ....4, 11, 13, 19

15 U.S.C. 78p(a), Securities Exchange Act § 16(a) 9, 17

15 U.S.C. § 78p(b), Securities Exchange Act § 16(b) ..... *passim*

28 U.S.C. § 455 6

28 U.S.C. § 1254(1) 2

28 U.S.C. § 1291 3

28 U.S.C. § 1331 3

Cited Authorities

Page

Rules:

17 C.F.R. § 240.13d-2 10

17 C.F.R. § 240.13d-3 13

17 C.F.R. § 240.13d-3(d)(1)(i) 2, 5, 14, 15

17 C.F.R. § 240.16a-1(a)(1) 2, 5

17 C.F.R. § 240.16a-1(c)(6) 18

17 C.F.R. § 240.16a-2(c) 8

17 C.F.R. § 240.16a-13 ..... 2, 20

17 C.F.R. § 240.16b-6(b) 2

Other Authorities:

Ownership Reports and Trading By Officers, Directors and Principal Security Holders, Exchange Act Release No. 28,869 [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) par. 84,709 (Feb. 8, 1991) 16

Realty South Investors, Inc., SEC No Action Letter, 1992 WL 139152 (June 17, 1992) 17

J. Stempel, *Update 3–Merrill sells $2 bln conv. bonds*, Reuters (May 18, 2001) 10

TABLE OF APPENDICES

Page

Appendix A — Opinion Of The United States Court Of Appeals For The Eighth Circuit Dated And Filed August 3, 2001 ..... 1a

Appendix B — Memorandum Opinion And Order Of The United States District Court For The District Of Minnesota Dated June 3, 1999 ..... 13a

Appendix C — Opinion Of The United States Court Of Appeals For The Eighth Circuit Dated July 24, 1998 ..... 39a

Appendix D — Memorandum Opinion And Order Of The United States District Court For The District Of Minnesota Dated August 4, 1997 ... 50a

Appendix E — Relevant Statutes And Codes 65a

Petitioner Morgan Capital, LLC ("Morgan Capital") respectfully requests that a writ of *certiorari* issue to review the judgment and opinion of the United States Court of Appeals for the Eighth Circuit entered on August 3, 2001. The Eighth Circuit held, *inter alia*, that a holder of convertible preferred securities could be liable under § 16(b) of the Securities Exchange Act of 1934 (the "Exchange Act") because prior to conversion the holder could hypothetically have received more than 10% of the outstanding common stock of the issuer had it converted on certain days, depending on the market price of the stock on a given day. The court's holding also places it in conflict with other courts, which hold that convertible securities having both fixed-priced and floating-priced features are not deemed "derivative" securities which would have exempted the transaction under the Exchange Act.

OPINIONS BELOW

The opinion of the Court of Appeals for the Eighth Circuit, captioned *Medtox Scientific, Inc. v. Morgan Capital, L.L.C.*, is reported at 258 F.3d 763 (8th Cir. 2001), and is reproduced at Appendix A hereto. That opinion affirmed the judgment and opinion of the United States District Court for the District of Minnesota, which is reported at 50 F. Supp. 2d 896 (D. Minn. 1999), and is reproduced at Appendix B. A prior opinion of the Eighth Circuit Court of Appeals in this case, captioned *Editek, Inc. v. Morgan Capital, L.L.C.*, is reported at 150 F.3d 830 (8th Cir. 1998), and is reproduced at Appendix C. That opinion reversed the judgment and opinion of the United States District Court for the District of Minnesota, which is reported at 974 F. Supp. 1279 (D. Minn. 1997), and is reproduced at Appendix D.

STATEMENT OF JURISDICTION

The judgment and opinion of the Eighth Circuit Court of Appeals was entered on August 3, 2001. The jurisdiction of this Court to review the judgment of the Eighth Circuit is invoked under 28 U.S.C. § 1254(1).

STATUTES AND RULES INVOLVED

The significant statutes and rules involved in the proceeding, which are set out in full at Appendix E, are: Section 16(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78p(b); Securities and Exchange Commission ("SEC") Rule 13d-3(d)(1)(i), 17 C.F.R. § 240.13d-3(d)(1)(i); SEC Rule 16a-1(a)(1), 17 C.F.R. § 240.16a-1(a)(1); SEC Rule 16b-6(b), 17 C.F.R. § 240.16b-6(b); and SEC Rule 16a-13, 17 C.F.R. § 240.16a-13.

STATEMENT OF THE CASE

This action arises from the sale on or about February 1, 1996, to petitioner Morgan Capital of convertible preferred stock of respondent Medtox Scientific, Inc. f/k/a Editek, Inc. ("Medtox") in a private placement pursuant to Regulation D promulgated under the Securities Act of 1933. Pursuant to the terms of the private placement offering documents, Morgan Capital could not exercise its conversion rights until the sixtieth day following the offering, or March 30, 1996. The conversion price was based on a "floating" price but had a "fixed" component as well in that there was a minimum number of shares of common stock that were to be issued upon conversion. JA-182-83.[1] Morgan Capital exercised its conversion right on

1. References to "JA" are to the Joint Appendix filed on the appeal to the Eighth Circuit Court of Appeals, whose opinion is the subject of this Petition.

May 1, 1996, which consequently was the first time Morgan Capital could know the number of shares of common stock it would be receiving as a result of the conversion. At conversion, Morgan Capital ended up with more than 10% of the outstanding shares of Medtox common stock. Morgan Capital then sold some of the common stock within six months of May 1, 1996. Respondent sued under § 16(b) of the Exchange Act to recover profits earned on the sale.

Respondent invoked the district court's jurisdiction pursuant to 28 U.S.C. § 1331 (federal question jurisdiction). Upon final judgment entered in the district court, an appeal was taken to the Eighth Circuit Court of Appeals pursuant to 28 U.S.C. § 1291.

A. The Facts

Before February 1, 1996, Morgan Capital did not own any Medtox securities. On or about February 1, 1996, Medtox issued to Morgan Capital, as part of a private placement of securities pursuant to Regulation D of the Securities Act of 1933, non-voting preferred stock that was convertible after sixty days into Medtox common stock. JA 14-15. The conversion price "floated" based on a trailing average price of Medtox common stock: 75% of the average trading price per share of common stock for the five trading days prior to the date of the exercise of the conversion right. JA 182-83. As a consequence, the person converting the shares would not know how many shares of common stock he would receive in the conversion until the conversion was actually exercised and the preceding five-day average closing price of the Medtox common stock was calculated. There was a "fixed" component of the conversion price, however, in that the number of shares of common stock to

be issued upon conversion could not be less than the quotient obtained by dividing $50,000 by $2.775. JA 182-83.

On May 1, 1996, Morgan Capital exercised its conversion rights. JA 15. Because of the slumping market price of the common stock, at conversion Morgan Capital received more than 10% of the outstanding common stock of Medtox. This was unintended even by Medtox; Medtox ran out of a sufficient number of common stock to meet the demands of all preferred holders exercising conversion rights. Within the next two months, Morgan Capital sold Medtox common stock. JA 26. Medtox then filed this action to recover "short-swing" profits under section 16(b) of the Exchange Act. JA 24.

B. The First District Court Opinion

The district court dismissed the complaint. 974 F. Supp. 1229 (D. Minn. 1997). (*See* Appendix D.) The court held that Morgan Capital did not become a beneficial owner until it actually exercised its conversion rights. Since that was the transaction that made Morgan Capital a beneficial owner of more than 10% of a class of equity securities of Medtox, it could not be matched with a subsequent sale for purposes of § 16 liability. *See Foremost-McKesson v. Provident Secs. Co.*, 423 U.S. 232, 252, 96 S. Ct. 508, 519, 46 L. Ed. 2d 464 (1976). The district court's decision was based on two independent grounds: (1) because Morgan Capital could not convert the preferred stock "within sixty days," Morgan Capital did not have the "right to acquire" "beneficial ownership" of any amount of Medtox common stock under § 13(d) of the Exchange Act, 15 U.S.C. § 78m(d) (which is incorporated into the § 16 regulatory analysis for

purposes of determining who is a "beneficial owner");[2] and (2) irrespective of whether Morgan Capital was a "beneficial owner" under § 13(d) of the Exchange Act, Morgan Capital could not be deemed the beneficial owner of more than 10% of the outstanding common stock of Medtox before actual conversion of the preferred shares because the right to acquire common stock by means of a conversion at a purchase price that was not fixed was not a vested right in the holder of the preferred shares until the price became fixed. 974 F. Supp. at 1231.

C. The First Eighth Circuit Opinion

Medtox appealed the dismissal of its case, and the Eighth Circuit reversed. 150 F.3d 830 (8th Cir. 1998). (*See* Appendix C.) The court's reversal was on one very narrow issue: that the district court had erred in holding that Morgan Capital was not a "beneficial owner" of Medtox common stock before conversion based on the district court's mistaken interpretation of the "within sixty days" test under § 13(d). 150 F.3d at 833. The court held that under § 13(d), Morgan Capital had the right to acquire beneficial ownership of Medtox common stock "on every day within sixty days of every day on which Morgan Capital" could convert its preferred stock. *Id.* at 833.

---

2. Rule 16a-1(a)(1) of the Rules promulgated under § 16 of the Exchange Act provides that in determining whether for purposes of § 16(b) liability a person is a ten percent beneficial owner — and thus a § 16(b) "insider" — the term "beneficial owner" has the meaning provided under § 13(d) of the Exchange Act. 17 C.F.R. § 240.16a-1(a)(1). Rule 13d-3(d)(1)(i) promulgated under § 13 of the Exchange Act provides that "[a] person shall be deemed to be the beneficial owner of a security . . . if that person has the right to acquire beneficial ownership of such security . . . within sixty days, including but not limited to any right to acquire: . . . (B) through the conversion of a security. . . ." 17 C.F.R. § 240.13d-3(d)(1)(i).

On that appeal, the Eighth Circuit did not decide two other issues: (1) whether a "holder of convertible preferred stock can[ ] 'float' into and out of ten percent ownership" under § 13(d) solely as a result of fluctuations in the market price of the underlying common stock; and (2) whether even assuming that prior to conversion Morgan Capital was a beneficial owner of more than 10% of Medtox's common stock (based on a hypothetical conversion at that time), did Morgan Capital's conversion of the preferred stock into common stock constitute a "purchase" that could be matched with a subsequent sale of the stock within six months for purposes of invoking liability under § 16(b), or was it merely a change in the form of beneficial ownership already taken into account in the hypothetical conversion and thus not a § 16(b) "purchase." *Id.* at 834-35. The case was remanded to the district court.

D. The Second District Court Opinion

On remand, Morgan Capital and the other defendants renewed their motion to dismiss the complaint for the failure to state a claim for relief under § 16(b) of the Exchange Act and for improper venue under § 27 of the Exchange Act. JA 243. Medtox opposed the motion and moved for partial summary judgment on its § 16(b) claim. JA 270. The district court denied defendants' motion to dismiss and granted Medtox's motion for partial summary judgment. 50 F. Supp. 2d 896 (D. Minn. 1999). (*See* Appendix B.)[3] The parties then dismissed their remaining respective claims and the claims against defendants other than Morgan Capital. JA 355-57. Final judgment was entered in the district court, JA 358-59, and Morgan Capital filed an appeal to the Eighth Circuit.

3. Judge Kyle, who had authored the first district court opinion in this case, recused himself from the case pursuant to 28 U.S.C. § 455.

E. The Second Eighth Circuit Opinion

By opinion dated August 3, 2001, the Eighth Circuit Court of Appeals affirmed the judgment of the district court. (*See* Appendix A.) The court held that Morgan Capital was to be deemed an "insider" for purposes of subjecting it to possible liability under § 16(b) "when it had the right ... to convert its preferred stock into more than 10% of Medtox's common stock," even though Morgan Capital had not actually converted the stock on that date (thus, a "hypothetical conversion") and "even if it had that status thrust upon it by operation of the market...." 258 F.3d at 767-68. The Eighth Circuit held that Morgan Capital's subsequent actual conversion was a separate transaction, *i.e.*, a purchase made after Morgan Capital was a 10% beneficial owner (by virtue of the hypothetical conversion), which could then be matched for § 16(b) liability purposes with sales made within the following six months. The court stated that the actual conversion can be deemed a "purchase" for § 16(b) purposes, without offering any real analysis as to how such a purchase was other than a change in the form of beneficial ownership. *Id.* at 768.[4]

4. The Court of Appeals also affirmed the district court's denial of that part of Morgan Capital's motion to dismiss which was based on improper venue, a matter that is not the subject of this Petition.

REASONS FOR GRANTING THE WRIT

I.

THE EIGHTH CIRCUIT'S OPINION WOULD SEVERELY RESTRICT THE USE OF CONVERTIBLE SECURITIES AND GENERATE CONFUSION IN THE SECURITIES MARKETS. THE ISSUE OF INSIDER TRADING STATUS FOR CONVERTIBLE SECURITIES SHOULD BE SETTLED BY THIS COURT.

This petition seeks review of the Eighth Circuit's novel expansion of the reach of § 16(b) of the Exchange Act with respect to convertible securities.

Liability against Morgan Capital was predicated on its allegedly engaging in short-swing securities transactions when it was *already* the beneficial owner of more than 10% of the outstanding common stock of Medtox. The Eighth Circuit reached that result only after treating the *possibility* of a conversion as an actual conversion and thereby concluding that Morgan Capital owned 10% of Medtox's common stock prior to any matching purchase and sale. Otherwise, Morgan Capital would not be subject to liability because it was not a 10% beneficial owner before its first purchase (*i.e.*, the actual conversion). *See* 17 C.F.R. § 240.16a-2(c) ("The transaction that results in a person becoming a ten percent beneficial owner is not subject to Section 16 of the [Exchange] Act unless the person otherwise is subject to Section 16 of the Act").

The court's holding was in error. Because the conversion price had a "floating" feature that fluctuated with the market movement of the underlying Medtox common stock, Morgan

Capital had no "right to acquire" any particular amount of Medtox common stock, much less 10%, until the actual conversion. Thus, the Eighth Circuit created a new class of imaginary beneficial ownership — one that arises on any day that the owner *could have* converted even if he did not. By retroactive judicial fiat, this creates broader liability for floating-price convertible securities than fixed-price convertibles[5] — a result opposite that intended by the SEC in fashioning precise amendments to the rules under § 16(b) in 1991.

Moreover, the Eighth Circuit's new rule change would generate chaos in the securities reporting requirements and the securities marketplace. According to the Eighth Circuit, all owners of preferred stock that have a feature making them convertible at trailing average "look-back" prices or similar pricing structures would be required to report continuously as they enter and exit the hypothetical 10% beneficial ownership threshold. Such investors would be subject to uncertainty regarding where they stand as to possible section 16 liability, as the price of the underlying equity security rises and falls, causing the prospective number of equity shares to be issued on conversion to fluctuate. This would create chaos with respect to the filing requirements imposed under sections 13(d) and 16(a) of the Exchange Act and corresponding schedules and forms.

For example, the holder of preferred shares that are convertible based on a floating conversion price would have to monitor and calculate on a daily basis the hypothetical number of shares he beneficially owns that day based on the

5. If the convertible preferred's fixed-price feature is considered, then the Eighth Circuit's holding would be in direct conflict with decisions of other courts. *See* Point II, *infra*.

prior days' average closing prices. On one day, if the market price of the underlying securities dropped, the owner would hypothetically own more than 10% of the outstanding equity securities and would, therefore, have to file a Form 3 indicating how many shares he would hypothetically acquire if the stock price remained the same. The very next day, if the price of the underlying common stock rose, the owner might find himself owning less than 10% on a hypothetical conversion and would have to amend the filings of the previous day. 17 C.F.R. § 240.13d-2 (requirement to file promptly an amendment showing change in the percentage of the class beneficially owned). This process would repeat itself. The effect would be mass confusion in the marketplace, both for the owner of the convertible securities as well as for others relying on the integrity of the reporting process.

It is no answer to suggest that the issuer and investors agree upon a "conversion cap" whereby by contract the investor cannot obtain upon conversion more than 10% of the outstanding equity security of the issuer. This unfairly and arbitrarily limits the value of convertible preferred securities and their utility as a capital raising mechanism for smaller companies that do not have the luxury of raising capital through public offerings of securities.

This is not an isolated concern. As of just May 2001, it was reported that companies already sold about $44.1 billion of convertible securities for the year. J. Stempel, *Update 3–Merrill sells $2 bln conv. bonds*, Reuters (May 18, 2001). The widespread use of convertible securities cannot be understated. Their utility in promoting capital investment and business growth would be detrimentally affected by subjecting investors to the uncertainty of potential § 16(b) liability based on the novel hypothetical conversion

rule espoused by the Eighth Circuit. Smaller companies, of course, rely on private offerings to raise capital. The spectre of § 16(b) liability when underlying stock prices decline in the natural course of events would cause investors to shun such offerings.

Moreover, investors in convertible preferred securities who purchase their securities with long term investment in mind suddenly face the onerous task of monitoring on a daily basis the market price of the underlying common stock so as to prevent the unintended cross-over into the area of 10% beneficial ownership through the Eighth Circuit's hypothetical conversion rule.

Putting aside the severe burden to such investors in convertible securities, other investors could no longer rely on the integrity of the reporting process to provide adequate disclosure. An essential purpose of § 13(d)'s reporting requirements is to "allow[ ] investors to be informed of potential changes in corporate control and permit[ ] the market to value the shares accordingly." *General Aircraft Corp. v. Lampert*, 556 F.2d 90, 94 (1st Cir. 1977). *See GAF Corp. v. Milstein*, 453 F.2d 709, 717 (2d Cir. 1971), *cert. denied*, 406 U.S. 910 (1972) (purpose of § 13(d) is to "alert the marketplace to every large aggregation or accumulation of securities"). This purpose would be frustrated if the Eighth Circuit's new rule of hypothetical 10% beneficial ownership were to be followed.

The Eighth Circuit's expansion of § 16 liability is in direct conflict with the principle espoused by the Second Circuit Court of Appeals and of this Court that § 16(b) is to be narrowly construed because of the strict liability aspect of the statute. *Gwozdzinsky v. Zell/Chilmark Fund, L.P.*,

156 F.3d 305, 310 (2d Cir. 1998) ("if speculative abuse alone were enough to invoke liability, then the more conventional purchases and sales that take place within six months and a day would result in liability, which plainly they do not"); *Levner v. Prince Alwaleed Bin Abdulaziz Al Saud*, 903 F. Supp. 452, 461 (S.D.N.Y. 1994), *aff'd*, 61 F.3d 8 (2d Cir. 1995) ("the Supreme Court has stressed a narrow approach to the statutory construction of section 16(b)"); *Levy v. Marshall Capital Management, Inc.*, Fed. Sec. L. Rep. (CCH) par. 91,230 (E.D.N.Y., July 28, 2000); *Levy v. Southbrook International Investments, Ltd.*, Fed. Sec. L. Rep. (CCH) par. 90,981 (S.D.N.Y., May 10, 2000).

Review by this Court is necessary to promote uniformity and regularity in the securities marketplace and avoid the confusion that novel rules for convertible securities would generate.

II.

THE EIGHTH CIRCUIT'S NOVEL HYPOTHETICAL CONVERSION RULE FOR CONVERTIBLE SECURITIES PRESENTS A CONFLICT AMONG THE COURTS WITH RESPECT TO POTENTIAL LIABILITY UNDER SECTION 16(b) OF THE EXCHANGE ACT.

The convertible preferred stock at issue here had a fixed-price feature in addition to the floating-price feature, for the number of shares of common stock to be issued upon conversion could not be less than the quotient obtained by dividing $50,000 by $2.775. JA-182-83. Although the Eighth Circuit disregarded the floating-price feature in fashioning its hypothetical conversion rule for determination of 10% beneficial ownership, the effect of the court's decision was

to negate the fixed-price feature of the security as well and the legal effects flowing from that feature. In so doing, the Eighth Circuit's holding conflicts with that of other courts which hold that a convertible preferred security having both a floating-price and fixed-price conversion feature should be treated only as a fixed-price security for purposes of deeming the security a "derivative" and its actual conversion a non-event for section 16 purposes.

A. The Eighth Circuit's Holding Conflicts With The Governing Regulations And Case Law

In the first place, the Eighth Circuit was incorrect in holding that a floating-priced convertible can cause the owner to beneficially own more than 10% of the underlying equity security before actual conversion. That holding alone conflicts with the governing regulations and case law. Sections 13 and 16 of the Exchange Act both require that a "beneficial owner" be one who has the "right to acquire" the securities upon conversion within sixty days.[6] Morgan Capital did not have the right to acquire *10%* of the outstanding common stock of Medtox before actual conversion. As this Court stated, the term "right" means an "ascertainable and legally enforceable power." *United States v. Byrum*, 408 U.S. 125, 136, 92 S. Ct. 2382 (1972). The phrase "right to acquire" as used in Rule 13d-3, therefore, means an ascertainable and legally enforceable right to obtain equity securities. *Allen v. Westpoint-Pepperell, Inc.*, Nos. 90 Civ. 3841, 89 Civ. 2016, 1996 WL 2004, at *6 (S.D.N.Y., Jan. 6, 1996). The "right to acquire" securities that is contingent upon events beyond the parties' control is not an enforceable right giving rise

6. The determination of a 10% beneficial owner for purposes of § 16 of the Exchange Act is derived from the definition set forth in 17 C.F.R. § 240.13d-3.

to "beneficial ownership" status. *Id. See also Transcon Lines v. A.G. Becker*, 470 F. Supp. 356, 371 (S.D.N.Y. 1979) (holding that where the exercise of a right to beneficial ownership is contingent on a future event, defendant is not to be deemed a beneficial owner under § 13(d)).

In our case, Morgan Capital never had the ascertainable and enforceable right to acquire 10% of the outstanding common stock of Medtox before Morgan Capital actually converted the preferred stock and the five-day trailing average "look-back" floating exercise price was computed. Morgan Capital may have had the right to acquire common stock and, therefore, may have been a "beneficial owner." But significantly, Rule 13d-3(d)(1)(i), insofar as the "within sixty days" rule is concerned, does not speak of a specific number of securities. Before actual conversion, Morgan Capital had no right to acquire any specific amount of Medtox common stock, much less 10% of all of Medtox's outstanding shares. The amount of such shares and thus the percentage of all such shares outstanding was not fixed, and was subject to market fluctuations until the day of conversion *See Levner v. Prince Alwaleed Bin Abdulaziz Al Saud*, 61 F.3d 8 (2d Cir. 1995) (common stock underlying convertible preferred stock deemed not to be beneficially owned for purposes of 10% ownership computation where right to convert was subject to material contingency outside holders' control).

In addition, before actual conversion, the regulatorily mandated calculation of the number of outstanding equity securities beneficially owned cannot be made. Rule 13d-3(d)(1)(i) (which is incorporated into the Rule 16 regulations) provides: "[a]ny securities not outstanding which are *subject to* such options, . . . or conversion privileges shall be deemed to be outstanding for the purpose of computing the percentage

of outstanding securities of the class owned by such person. . . ." 17 C.F.R. § 240.13d-3(d)(1)(i) (emphasis added). In the case of floating-price convertible securities, prior to conversion (before the conversion price becomes fixed), the number of securities *subject to* the conversion privilege cannot be determined for purposes of calculating the percentage of securities outstanding that is owned by the owner of the conversion privilege.

In sum, the Eighth Circuit's hypothetical conversion rule for 10% beneficial ownership is inconsistent with the regulatory framework.

B. By Ignoring Both The Floating-Price And Fixed-Price Features Of The Medtox Convertible Preferred, The Eighth Circuit's Holding Conflicts With Decisions Of Other Courts

In the court below, petitioner focused on the floating-priced feature of the Medtox convertible preferred because the court was dealing first with the determination of 10% beneficial ownership. As petitioner argued, prior to actual conversion such determination could not be made consistent with the regulatory framework and as a matter of fact. The import of the holding of the Eighth Circuit, however, goes far beyond the treatment of convertible preferred securities with floating-price conversion features. The court's holding ignores completely the fixed-price feature of the security and in so doing propels it on a collision course with other courts that have treated the matter differently.

With respect to convertible securities, whether the exercise of a conversion right constitutes a "purchase" for section 16 purposes depends on whether the convertible is a fixed-price convertible security, denominated a "derivative," or is not a

fixed-price security, such as a floating-price convertible preferred security. It is either one or the other. The *acquisition* of a fixed-price derivative is deemed a "purchase" for section 16 purposes. Its actual exercise is a non-event. The reverse holds true for floating-priced securities. Its *exercise* constitutes the "purchase" for such securities; its acquisition is the non-event. The regulations do not speak of hybrid convertibles: those like the Medtox preferred stock which have both a floating-price and fixed-price feature.

The SEC has made it very clear that

> a right with a floating exercise price is not required to be reported and will not be deemed to be acquired or purchased, for section 16 purposes, until the purchase price of the underlying securities becomes fixed or established, which commonly occurs at exercise.

Ownership Reports and Trading By Officers, Directors and Principal Security Holders, Exchange Act Release No. 28,869 [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) par. 84,709, at 81,265 (Feb. 8, 1991) (hereafter referred to as "SEC Release"). The rationale for this rule is that floating-price convertible securities and similar rights do "not provide the same kind of opportunity for short-swing profit as a right with a fixed exercise price. . . ." *Id. See also Lerner v. Millenco, L.P.*, 23 F. Supp. 2d 337, 341-42 (S.D.N.Y. 1998) (same). The SEC concluded that with floating-price rights, the primary potential for short-swing "abuse"

> arises at the time of exercise for a floating price derivative security because only at exercise is the price fixed and, therefore, the extent of the profit opportunity defined. By treating the exercise of the

> floating price derivative security as the "acquisition" of the underlying security, the rules mitigate the incentives for insiders to abuse their informational advantage.

SEC Release, at 81,265 n.148.[7]

The SEC also has held that the holder of a convertible preferred security with a floating conversion price feature, a "reset adjustment," would not be subject to § 16(a) of the Exchange Act "from the date of acquisition of the Preferred Shares until the Reset Date." SEC No Action Letter, *Realty South Investors, Inc.*, 1992 WL 139152 at *8 (June 17, 1992) (JA 259). Significantly, the reset adjustment in *Realty South* operated in a similar way that the convertible floating-price feature operated in our case, in that the number of shares of common stock that would be received on the reset date depended on the market price of the stock as of the reset date. *Id.* at *2. It is thus clear that according to the SEC, 10% beneficial ownership cannot be determined for floating-price convertible securities until the conversion price is fixed.

Putting aside the fact that the Eighth Circuit's holding conflicts with the SEC regulations governing floating-priced securities, it also ignores the fixed-price feature that renders the security a "derivative."

---

7. An agency's "reasonable interpretation of a statute that Congress has entrusted the agency to administer," is entitled to much weight. *Europe & Overseas Commodity Traders, S.A. v. Banque Paribas Global Bond Futures Fund*, 147 F.3d 118, 123 n.3 (2d Cir. 1998), *cert. denied*, 525 U.S. 1139 (1999) (citing *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 842-45, 104 S. Ct. 2778, 2781-83 (1984)).

An essential purpose of the 1991 rule changes was to curb the potential short-swing profit abuse by insiders owning derivative securities, *i.e.*, those where the right (such as an option or convertible feature) has a fixed price. SEC Release at 81,258-59. As stated above, with respect to derivative securities, it is the acquisition of the derivative that constitutes the purchase. The exercise of that right (such as conversion), however, is not considered a purchase for purposes of matching it against sales within a six month period, because the exercise only "changes the form of beneficial ownership from indirect to direct." *Id.* at 81,259. If the Medtox convertible preferred would have been deemed a fixed-price derivative security, then the actual exercise of the conversion would not be considered a "purchase" and petitioner would not be liable under § 16(b) of the Exchange Act.

As shown below, other courts would have treated the Medtox security as a fixed-price security — a "derivative" — with the consequence that no liability would attach to the actual exercise of the conversion right.

In *Levy v. Oz Master Fund, Ltd.*, 00 Civ. 7148 (AGS), 2001 U.S. Dist. LEXIS 9251 (S.D.N.Y. July 9, 2001), Judge Schwartz of the Southern District of New York held that a convertible security having both floating-priced and fixed-price features similar to that of our case is deemed a "derivative."[8] Although the court noted that Rule 16a-1(c)(6) expressly excludes from the definition of derivatives any "rights with an exercise or conversion privilege at a price that is not fixed," 17 C.F.R. § 240.16a-1(c)(6), it held that an investor of a convertible

8. A notice of appeal to the Court of Appeals for the Second Circuit was filed in the *Levy* case on August 7, 2001.

security having both fixed and floating price features is able to "lock in his position" and thereby reap the potential for profit when the security is acquired — the attribute of a derivative security. *Id.* at *15-18.

The *Levy* court also noted that courts have reached different conclusions. In *Lerner v. Millenco L.P.*, 23 F. Supp. 2d 337 (S.D.N.Y. 1998), Judge Scheindlin of the Southern District of New York held that "a convertible debenture with . . . a hybrid pricing feature must be classified as a 'derivative security' for purposes of Rule 16a-1(c) and (d)." *Id.* at 342. By contrast, the Delaware District Court in *Levy v. Clearwater Fund IV, Ltd.*, 2000 U.S. Dist. LEXIS 1305, No. Civ. A. 99-004-SLR (D. Del. Feb. 2, 2000), held that convertible securities with hybrid conversion price features are not derivative securities.

We respectfully suggest that the reasoning of Judges Schwartz and Scheindlin of the Southern District of New York is more analytically correct and logical. The fixed-price feature of a convertible security cannot simply be ignored. Profit is locked in at the time of the acquisition of the security. The floating-price feature only increases that profit potential.

But the Eighth Circuit in our case did not just ignore the fixed-price feature. It treated the Medtox security as a floating-priced convertible for purposes of not classifying it as a "derivative security" whose actual conversion would be a non-event under section 16(b). But when confronted with the SEC's pronouncement that "a right with a floating exercise price is not required to be reported and will not be deemed to be acquired or purchased, for section 16 purposes, until the purchase price of the underlying securities becomes fixed or established, which commonly occurs at exercise,"

the court treated the Medtox security as if it were a fixed-price derivative security, by holding that a purchase occurred before actual conversion. In so doing, the Eighth Circuit not only fashioned a new rule for hybrid convertible preferred securities (those with floating-priced and fixed-price features), but it also ignored the plain fact that all that actual conversion effected in our case, as is the case with any derivative security, is a change in the form of beneficial ownership — again a non-event for section 16(b) purposes. And if the Medtox convertible was not a fixed-price derivative, according to the SEC actual conversion still should have been considered a non-event for the same reason. 17 C.F.R. § 240.16a-13 provides:

> A transaction other than the exercise or conversion of a derivative security ... that effects only a change in the form of beneficial ownership without changing a person's pecuniary interest in the subject equity securities shall be exempt from section 16 of the Act.

According to the Eighth Circuit, convertible preferred securities with floating-price and fixed-price features have rules of their own — rules not promulgated by Congress, nor by the SEC nor dictated by logic, and in conflict with the decisions of other courts.

Securities are offered and issued nationwide, and their regulation must be conducted on a uniform, national level. An investor's exposure to liability under § 16(b) of the Exchange Act should not depend on a particular venue, or more precisely, the judicial forum selected by plaintiff's counsel (as occurred in our case). An investor should not be

faced with uncertainty in making investment decisions that his actions may have repercussions because one particular court treats his securities differently than other courts.

Granting this requested writ will permit the Court to deal with the appropriate treatment to be given to all convertible securities under section 16(b) of the Exchange Act in a uniform manner that will clarify the regulatory framework and provide certainty in the marketplace.

CONCLUSION

For all of the foregoing reasons, petitioner respectfully urges the Court to grant this petition and issue a writ of certiorari to the United States Court of Appeals for the Eighth Circuit in order to address these issues of national importance.

Respectfully submitted,

SUSAN G. KELLMAN
Counsel of Record for Petitioner
c/o STAHL & ZELMANOVITZ
767 Third Avenue
New York, New York 10017
(212) 826-6422

JOSEPH ZELMANOVITZ
Of Counsel

APPENDIX A — OPINION OF THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT DATED AND FILED AUGUST 3, 2001

UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

No. 00-3719

Medtox Scientific, Inc., formerly known as Editek, Inc.,

Plaintiff/Appellee,

v.

Morgan Capital, L.L.C.,

Defendant/Appellant,

Alex Bistricer, David Bistricer,

Defendants.

Appeal from the United States District Court for the District of Minnesota.

Submitted: June 11, 2001

Filed: August 3, 2001

Before WOLLMAN, Chief Judge, HAMILTON,[1] and MURPHY, Circuit Judges.

---

1. The Honorable Clyde H. Hamilton, United States Circuit Judge for the Fourth Circuit, sitting by designation.

Appendix A

WOLLMAN, Chief Judge.

Morgan Capital, L.L.C. appeals from a district court[2] order requiring it to disgorge the profits of short-swing stock sales. We affirm.

I.

The facts of this case are undisputed. On February 1, 1996, Medtox Scientific, Inc.[3] issued shares of preferred stock. The preferred stock was convertible to Medtox's common stock, at the option of the holder, at a price equal to the average closing price of the common stock for the five trading days preceding the notice of conversion. The conversion right became exercisable on March 30, 1996. Morgan Capital purchased preferred stock in the offering. In a hypothetical conversion on the date of purchase, Morgan Capital would have received less than 10% of Medtox's common stock. David and Alex Bistricer, officers and controlling principals of Morgan Capital's operations, served on Medtox's Board from July 1996 to June 1997.

On March 28, 1996, the price of Medtox common stock dropped to a point where, had Morgan Capital converted its preferred shares to common stock, it would have received more than 10% of the total common stock. As the value of

---

2. The Honorable Ann D. Montgomery, United States District Judge for the District of Minnesota.

3. In the course of this litigation, the plaintiff-appellee has changed its name from Editek to Medtox; we will identify the corporation as Medtox.

Appendix A

Medtox's common stock declined, the Bistricers made weekly phone calls to Medtox's management to discuss the company's affairs. Had Morgan Capital exercised its conversion right on any day between April 9 and May 1, it would have acquired more than 10% of Medtox's common stock. On May 1, 1996, Morgan Capital converted all of its preferred stock and received more than 10% of the shares of Medtox's common stock. In May and June of 1996, Morgan Capital sold some of its shares of common stock, realizing a profit of $576,785.80.

Section 16(b) of the Securities Exchange Act of 1934 requires disgorgement of profits from short-swing stock transactions (a matching purchase and sale of stock within six months) by insiders.

> For the purpose of preventing the unfair use of information which may have been obtained by [a] beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) within any period of less than six months .. . shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer .. . .

15 U.S.C. § 78p(b).

Section 16(a) of the Act defines a "beneficial owner" as "[e]very person who is directly or indirectly the beneficial

owner of more than 10 per centum of any class of any equity security . . . ." 15 U.S.C. § 78p(a). The applicable regulations refer to § 13(d) of the Securities Exchange Act and its regulations for the definition of "beneficial owner" in § 16(a). 17 C.F.R. § 240.16a-1(a)(1).[4] Under the § 13(d) regulations, "a person shall be deemed to be the beneficial owner of a security . . . if that person has the right to acquire beneficial ownership of such security . . . within sixty days ... through the conversion of a security." 17 C.F.R. § 240.13d-3(d)(1)(i)(B). Thus, the owner of a conversion right is deemed the beneficial owner of the security it has a right to acquire through conversion. The term "beneficial owner" in § 16(b) refers to the class of beneficial owners who own more than 10% of a class of one company's stock and have access to, and an opportunity to exploit, corporate information not generally available to the public. *See Foremost-McKesson, Inc. v. Provident Secs. Co.*, 423 U.S. 232, 253 (1976).

In Medtox's initial action for disgorgement, the district court held that Morgan Capital was not a beneficial owner of Medtox common stock until it converted its preferred stock to common stock. Because a purchase of stock that puts a holder over the 10% threshold does not count as a purchase for purposes of determining whether a short swing profit must be disgorged, *see id.* at 254, and Morgan Capital had not owned more than 10% of the preferred stock, the court dismissed the action for failure to state a claim. *Editek, Inc.*

---

4. Morgan Capital has also directed our attention to provisions containing yet another definition of beneficial ownership in relation to derivative securities. Because, as Morgan Capital acknowledges, none of the securities involved in this transaction were derivatives, these provisions are inapposite.

v. Morgan Capital, L.L.C., 974 F. Supp. 1229 (D. Minn. 1997) (*Editek I*). We reversed and held that, under the "within sixty-days rule," Morgan Capital was by virtue of its option to convert a beneficial owner of Medtox Common stock once it had acquired the preferred stock. *Editek, Inc. v. Morgan Capital, L.L.C.*, 150 F.3d 830, 833 (8th Cir. 1998) (*Editek II*). We expressly did not decide whether Morgan Capital had met the 10% threshold prior to its stock conversion, instead remanding the case to the district court for a determination of this question.

On remand, the district court held that Morgan Capital was a beneficial owner of more than 10% of Medtox's common stock when the stock price dropped to the point that a conversion of stock would have given Morgan Capital more than 10% of the common stock, that its conversion was a purchase for purposes of determining whether a short-swing transaction had taken place, and that the profits from Morgan Capital's sale of Medtox stock within six months of that purchase were subject to disgorgement under § 16(b). *Medtox Scientific, Inc. v. Morgan Capital, L.L.C.*, 50 F.2d 896, 907 (D. Minn. 1999). The court also considered for the first time on remand Morgan Capital's challenge to venue and concluded that venue was proper in the district of Minnesota because some of the events leading up to the transactions, although not the transactions themselves, took place in Minnesota. *Id.* at 906. The court entered judgment in favor of Medtox in the amount of $675,000, which included prejudgment interest and the profits subject to disgorgement.[5] *Id.*

---

5. That amount reflects an amended calculation of the total profits of the common stock sales as agreed by the parties in a consent decree.

Appendix A

II.

Morgan Capital raises three arguments on appeal. First, it contends that the district court erred in holding that Morgan Capital was an owner of more than 10% of the common stock, and hence an insider for purposes of § 16(b), before it converted its preferred stock to common stock.[6] Second, it argues that the court erred in holding that its conversion of the stock was a purchase for purposes of that section. Third, it asserts that venue was improper in the District of Minnesota.

A. Insider Status

Section 16(b) does not apply in the instant case unless Morgan Capital was an insider at the time of the transactions. Morgan Capital was not an officer or director of Medtox at that time, and it was therefore not an insider unless it was a "beneficial owner" within the meaning of that term as used in § 16(b). Section 16(a) defines "beneficial owner" as used in § 16(b) as a "beneficial owner of more than 10 per centum of any class of any equity security." The Securities Exchange Commission (SEC) regulations define "beneficial owner" as used in § 16(a) as including those with a right to acquire the stock within sixty days. 17 C.F.R. § 240.16a-1(a)(1). Therefore, in order to be an insider subject to disgorgement, at the time of the purchase and sale of the common stock

---

6. Because the bulk of the confusion in this case comes from the multiple meanings of "beneficial owner" within the Securities Exchange Act and particularly within § 16, *see Editek II*, 150 F.3d at 834, for the purposes of this opinion, we use the term "insider" to denote someone whose actions are subject to § 16(b).

Morgan Capital must have been a "beneficial owner" (as defined by the regulations) of more than 10% of the common stock. *See Editek II*, 150 F.3d at 832-33. In *Editek II*, we determined that Morgan Capital was a § 16(a) beneficial owner at the time of the conversion. *Id.* Thus, § 16(b) applies to the conversion and sale if Morgan Capital's beneficial ownership of the common stock established in *Editek II* exceeded 10% of the common stock.

Morgan Capital argues that § 16(b) does not require it to disgorge its profits because a short-swing sale and purchase requires three separate transactions (an initial transaction giving rise to the insider status, followed by a matchable purchase and sale), and there were only two transactions in this case (purchase and sale). It argues that it was not an insider until the preferred stock was converted into common stock because the conversion price was floating, rather than fixed, and that therefore it was not the beneficial owner of any particular quantity of common stock until it exercised its conversion option. By this reasoning, because the purchase of stock which creates insider status cannot be considered in locating a matching purchase and sale under § 16(b), *see Editek II*, 150 F.3d at 831, Morgan Capital is not required to disgorge the profits from its sale of the common stock. We disagree.

We conclude that Morgan Capital was an insider on any day when it had the right, applying the conversion formula, to convert its preferred stock into more than 10% of Medtox's common stock. At any point in time, the conversion value of the preferred stock was readily ascertainable because it depended only on past events (i.e., the market price of the

common stock for the preceding five days). It is undisputed that, unless Morgan Capital became an insider prior to exercising its conversion rights, § 16(b) does not apply and disgorgement of profits is not required. *See Editek II*, 150 F.3d at 831 ("the acquisition that takes a buyer above ten percent ownership does not count as a 'purchase' matchable against a later sale for § 16 purposes"). Morgan Capital's purchase of preferred stock in February of 1996 did not make it an insider because Morgan Capital did not have a right to acquire more than ten percent of the common stock. Instead, Morgan Capital gained the ability to acquire more than 10% of the common stock passively through the operation of the market rather than by an affirmative act of its own. Under our holding in *Editek II*, Morgan Capital was a "beneficial owner" of Medtox common stock within the meaning of § 13(d) "on every day within sixty days on which [it] had the right to acquire Editek common stock through conversion," including May 1, 1996. *See Editek II*, 150 F.3d at 833. The determinative question, then, is whether Morgan Capital became a beneficial owner of more than 10% of the common stock prior to the conversion.

The district court answered this question in the affirmative, reasoning that the relevant indicator of insider status was the amount of common stock Morgan Capital had a right to acquire at the time of the conversion, rather than whether Morgan Capital had taken affirmative steps to gain insider status.

> After March 30, 1996, if Morgan Capital could have converted its Preferred Stock into more than ten percent of the outstanding shares of

> [Medtox's] Common Stock on any given day, then the presumption arises under Section 16(b) that Morgan Capital's holdings afforded it the potential for access to corporate information not available to a smaller shareholder on that day .... At the same time, however, due to the floating conversion rate of the Preferred Stock, Morgan Capital's standing as a "ten percent beneficial owner" was potentially subject to change daily. Thus, to establish liability under Section 16(b), Plaintiff will ... have to show ... that Morgan Capital could have obtained more than ten percent of the Common Stock on the day before it actually made the illicit purchase — April 30, 1996. Otherwise, Morgan Capital presumably would not have had access to inside information when it actually purchased the Common Stock and, therefore, would not be subject to the strictures of Section 16(b).[7]

Medtox, 50 F. Supp. 2d at 903.

We agree with the district court's analysis. We held in *Editek II* that beneficial ownership does not depend on an affirmative act of acquisition or a distinct transaction. *Editek II*, 150 F.3d at 833. A short-swing transaction requires a pre-existing status (insider) and two transactions (purchase and sale). Once the fact of beneficial ownership is established,

---

7. Because the conversion formula calculates the conversion rate based on the five days prior to the conversion demand, Morgan Capital could calculate at the close of the market on April 30 how much common stock it would receive in a May 1 conversion.

the matter of determining what portion of the common stock is beneficially owned is a matter of applying the mathematical formula set out by the preferred stock.[8] Morgan Capital was an insider on every day when it had the right to acquire more than ten percent of the common stock, and even if it had that status thrust upon it by operation of the market, it is still subject to the strictures of § 16(b).

Morgan Capital acknowledges that as of April 30, 1996, exercise of its conversion right entitled it to more than 10% of Medtox's common stock. Moreover, Morgan Capital's conduct during the months leading up to the conversion and sale comports with the sort of exploitation of inside information that the statute guards against. The Bistricers were in regular contact with Medtox officers, had close connections to the company, and were privy to insider information. Thus, the district court correctly determined that Morgan Capital was an insider when it converted its preferred stock to common stock.

B. Conversion of Stock as a Purchase

Morgan Capital next argues that if it was the beneficial owner of the Medtox common stock prior to conversion, then its conversion of preferred stock is not a purchase for § 16(b) purposes but merely a change in the form of beneficial ownership. Under Rule 16a-13 of the applicable regulations,

---

8. We note, as did the district court, that a case in which the calculation of or right to acquire the security depends on contingent or future events at the time of conversion would present a different question. *See, e.g., Levner v. Prince Alwaleed*, 61 F.3d 8 (2d Cir. 1995); *Transcon v. A.G. Becker, Inc.*, 470 F. Supp. 356 (S.D.N.Y. 1979).

a transaction that effects only a "change in the form of beneficial ownership" is exempt from § 16(b) liability. 17 C.F.R. § 240.16a-13. In *Editek II*, however, we held that for purposes other than determining insider status, Morgan Capital was not a beneficial owner of the common stock until it exercised its conversion rights.

> In other words, Morgan Capital, as holder of floating-price convertible Preferred Stock, did not own derivative securities, did not have an indirect pecuniary interest in the underlying common stock, and accordingly (assuming Morgan Capital had no other form of pecuniary interest) was not a beneficial owner of the common stock until the conversion — for purposes *other* than ten percent beneficial ownership. It may seem odd that Morgan Capital both was and was not a beneficial owner of [Medtox] common before the conversion but the SEC has long recognized the two different definitions of *beneficial owner* can result in different determinations of beneficial ownership.

150 F.3d at 834.

The SEC has made clear that conversion is a purchase for the purposes of determining whether a § 16(b) purchase and sale transaction has occurred.

> [A] right to purchase an equity security is deemed acquired as of the date the exercise or conversion price becomes fixed, and the acquisition, absent an exemption, will be matchable for § 16(b) purposes with a disposition within six months of

> the fixing of the price. For example, the acquisition of an option having an exercise price equal to 90% of the market price as of the date of exercise would be deemed to be a purchase of the underlying stock as of the date of exercise.

Ownership Reports and Trading By Officers, Directors and Principal Security Holders, S.E.C. Release Nos. 34-28869, 35-2524, IC-12,991, 1991 WL 292000 at *18 (1991). Thus, the conversion was a purchase for purposes of § 16(b). Consequently, the district court was correct in determining that Morgan Capital was an insider that profited from a purchase and sale of Medtox's common stock within a six-month period and that under § 16(b), that profit must be disgorged.

C. Venue

Finally, Morgan Capital contends that venue was not proper in the District of Minnesota. Under § 27 of the Securities Exchange Act, venue for a § 16(b) action is proper only in the district where (1) the defendant is found or is an inhabitant or transacts business, or (2) any act or transaction constituting the violation occurred. 15 U.S.C. § 78aa. The Bistricers repeatedly placed phone calls to the Minnesota offices of Medtox in order to obtain information about the company's finances on Morgan Capital's behalf, served on the Medtox's Board for approximately one year while Medtox was based in Minnesota, and personally toured the company's facilities there. We agree with the district court's conclusion that because Morgan Capital transacts business in Minnesota, venue was proper there.

The judgment is affirmed.

APPENDIX B — MEMORANDUM OPINION AND ORDER OF THE UNITED STATES DISTRICT COURT FOR THE DISTRICT OF MINNESOTA DATED JUNE 3, 1999

UNITED STATES DISTRICT COURT
DISTRICT OF MINNESOTA

No. Civ. 97-253 ADM/AJB

MEDTOX SCIENTIFIC, INC., f/k/a Editek, Inc.,

Plaintiff,

v.

MORGAN CAPITAL L.L.C., Alex Bistricer, and David Bistricer,

Defendants.

June 3, 1999.

* * *

MEMORANDUM OPINION AND ORDER

MONTGOMERY, District Judge.

I. INTRODUCTION

Plaintiff Medtox Scientific, Inc. ("Medtox"), f/k/a Editek, Inc. ("Editek"),[1] filed this action on January 31, 1997,

1. After this action was commenced, Editek changed its name to Medtox. For purposes of clarity and consistency with prior opinions issued in this case by both the district and appellate courts, references to Plaintiff in this decision will be to Editek.

to recover alleged short-swing insider profits realized by Defendant Morgan Capital L.L.C. ("Morgan Capital") and its alleged control persons, Defendants Alex and David Bistricer ("Bistricers"), on a series of 1996 transactions involving Editek stock. On August 4, 1997, Judge Richard H. Kyle of this Court dismissed Plaintiff's Complaint for failure to state a claim upon which relief can be granted. *See Editek v. Morgan Capital, L.L.C.*, 974 F.Supp. 1229 (D.Minn.1997) ("*Editek I*"). Plaintiff appealed the decision, and on July 24, 1998, the Eighth Circuit Court of Appeals reversed the district court judgment and remanded the case for further proceedings. *See Editek v. Morgan Capital, L.L.C.*, 150 F.3d 830 (8th Cir.1998) ("*Editek II*"). Judge Kyle subsequently recused himself from the case pursuant to 28 U.S.C. § 455, and it was reassigned to the undersigned United States District Judge. The matter is currently before the Court on Defendants' Motion to Dismiss the Complaint and Plaintiff's Motion for Partial Summary Judgment. For the reasons set forth below, Defendants' motion is denied and Plaintiff's motion is granted.

II. DEFENDANTS' 12(b)(6) MOTION

Rule 12 of the Federal Rules of Civil Procedure provides that a party may move to dismiss a complaint for failure to state a claim upon which relief can be granted. Fed.R.Civ.P. 12(b)(6) ("Rule 12(b)(6)"). In considering a motion to dismiss, the pleadings are construed in a light most favorable to the plaintiff, and the facts alleged in the complaint must be taken as true. *See Hamm v. Groose*, 15 F.3d 110, 112 (8th Cir.1994); *Ossman v. Diana Corp.*, 825 F.Supp. 870, 879-80 (D.Minn.1993). Any ambiguities concerning the sufficiency

of the claims must be resolved in favor of the nonmoving party. *See Ossman*, 825 F.Supp. at 880. A complaint should be dismissed pursuant to Rule 12(b)(6) "only if it is clear that no relief can be granted under any set of facts that could be proved consistent with the allegations." *Frey v. City of Herculaneum*, 44 F.3d 667, 671 (8th Cir.1995) (citations omitted). In other words, "[a] motion to dismiss should be granted as a practical matter . . . only in the unusual case in which the plaintiff includes allegations that show on the face of the complaint that there is some insuperable bar to relief." *Frey*, 44 F.3d at 671.

A. The Complaint

On or about February 1, 1996, Editek, a Delaware corporation with its principal place of business in Minnesota, issued shares of Convertible Preferred Stock ("Preferred Stock") in an offering conducted under Section D of the Securities Act of 1933 ("the Offering"). Compl. ¶¶ 2, 11. At the option of the holder, each share of Preferred Stock was convertible to Editek common stock ("Common Stock") at a price equal to the average closing price of the shares of Common Stock for the five trading day period preceding the date notice of conversion was given to Editek by such holder. *Id.* ¶ 12. Consequently, the number of shares of Common Stock that the Preferred Stock would buy floated with the average trading price of the Common Stock. As the trading price of the Common Stock declined, the number of shares of Common Stock that the Preferred Stock would buy increased, and vice-versa. The right to convert the Preferred Stock was not exercisable until 60 days after issuance of the shares. *Id.*

Appendix B

Morgan Capital, a limited liability corporation with offices in Brooklyn, New York, purchased Preferred Stock from Editek in the Offering. Compl. ¶¶ 3, 13. At the time of its purchase, the number of shares of Common Stock that Morgan Capital would have received upon conversion of its Preferred Stock (were it allowed to immediately convert the stock) would have been less than ten percent of the outstanding shares of Editek's Common Stock. *Id.* ¶ 13.

On March 28, 1996, as a result of a decline in the price of the Common Stock, the amount of shares of Common Stock that Morgan Capital would have received upon conversion of its Preferred Stock (again, were it allowed to convert the stock at such time) would have been greater than ten percent of the outstanding shares of Editek's Common Stock. Compl. ¶ 14. March 30, 1996, marked the first day upon which Morgan Capital was eligible to convert its Preferred Stock into Common Stock. *See Editek II*, 150 F.3d at 832.

On May 1, 1996, Morgan Capital converted all of its Preferred Stock into Common Stock. Compl. ¶ 15. The Common Stock that Morgan Capital received in the conversion amounted to greater than ten percent of the outstanding shares of Editek's Common Stock. *Id.* Morgan Capital then sold a portion of its shares of Common Stock on five separate occasions in May and June 1996, realizing a profit of at least $500,000. *Id.* ¶¶ 17, 18.

B. Section 16(b)

In its sole claim for relief, Editek alleges that Morgan Capital's conduct violated Section 16(b) of the Securities

Appendix B

Exchange Act of 1934 ("the Exchange Act"), 15 U.S.C. § 78p(b). Section 16(b) was enacted to prevent corporate "insiders" from abusing their fiduciary positions "by using confidential corporate information to aid their personal market activities." *Petteys v. Butler*, 367 F.2d 528, 532 (8th Cir.1966), *cert. denied*, 385 U.S. 1006, 87 S.Ct. 712, 17 L.Ed.2d 545 (1967). The statute provides in relevant part as follows:

> For the purpose of preventing the unfair use of information which may have been obtained by [a] beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months. . . .

15 U.S.C. § 78p(b). The term "beneficial owner" is defined in Section 16(a) as "[e]very person who is directly or indirectly the beneficial owner of more than 10 per centum of any class of any equity security (other than an exempted security) which is registered pursuant to section 78l" of the Act. 15 U.S.C. § 78p(a). The so-called "ten percent beneficial

owners" are considered insiders, and therefore included within the statute's reach, because "the size of their holdings afford[s] the potential for access to corporate information." *Foremost-McKesson, Inc. v. Provident Secs. Co.*, 423 U.S. 232, 253, 96 S.Ct. 508, 46 L.Ed.2d 464 (1976).

Determining who qualifies as a ten percent beneficial owner under Section 16(b) is no simple task. Rule 16a-1 of the governing regulations states the following:

> Solely for purposes of determining whether a person is a beneficial owner of more than ten percent of any class of equity securities registered pursuant to section 12 of the [1934] Act, the term "beneficial owner" shall mean any person deemed a beneficial owner pursuant to section 13(d) of the Act and the rules thereunder ...

17 C.F.R. § 240.16a-1(a)(1). Under Section 13(d), a beneficial owner of a security includes any person who has voting power or investment power in relation to the security. *Id.* § 240.13d-3(a). Furthermore, "[a] person shall be deemed to be the beneficial owner of a security if that person has the right to acquire beneficial ownership of such security, as defined in Rule 13d-3(a) (§ 240.13d-3(a)) within sixty days ... [t]hrough the conversion of a security." *Id.* § 240.13d-3(d)(1)(i)(B) (" 'within sixty days' rule"). In other words, persons who have the right to acquire voting power or investment power in relation to a security within sixty days are deemed "beneficial owners" of that security for purposes of determining ten percent beneficial ownership.

Finally, "[t]o be liable under Section 16(b), a ten percent beneficial owner must have been such 'both at the time of the purchase and sale, or the sale and purchase, of the security involved.' " *Editek II*, 150 F.3d at 831 (quoting 15 U.S.C. § 78p(b)). Since owners below the ten percent threshold "presumptively lack[ ] access to inside information, the acquisition that takes a buyer above ten percent beneficial ownership does not count as a 'purchase' matchable against a later sale for Section 16(b) purposes." *Id.*

C. Prior Orders

Judge Kyle based his decision to dismiss Plaintiff's Section 16(b) claim on two separate grounds. First, he held that the "within sixty days" rule barred Plaintiff's claim because the Complaint did not allege that Morgan Capital had the ability to convert its Preferred Stock to more than ten percent of Common Stock on the sixtieth day after the Preferred Stock was issued (the first day that conversion was permissible under the terms of the Preferred Stock). *See Editek I*, 947 F.Supp. at 1233. Without such an allegation, Judge Kyle reasoned that Plaintiff could not show Morgan Capital was a beneficial owner of Editek Common Stock prior to the May 1, 1996, conversion because Morgan Capital did not have the right to acquire ten percent of the outstanding shares of such stock within sixty days of acquiring the Preferred Stock. *Id.*; *see also Editek II*, 150 F.3d at 833.

As an alternative basis for dismissal, Judge Kyle examined the floating exercise price at which the Preferred Stock was convertible to Common Stock in light of the following passage from a 1991 SEC Release:

> [A] right with a floating exercise price is not required to be reported and will not be deemed to be acquired or purchased, for Section 16 purposes, until the purchase price of the underlying securities becomes fixed or established, which commonly occurs at exercise. Thus, a right to purchase an equity security is deemed acquired as of the date the exercise or conversion price becomes fixed.

Editek I, 974 F.Supp. at 1233. Because the conversion price of the Common Stock could not be determined or fixed until the date Morgan Capital gave notice to Editek of its desire to convert, Judge Kyle reasoned that the "right [to acquire] referred to in the ownership provision [the "within sixty days" rule] could not be attributed to Morgan Capital until the day it actually converted its Preferred Stock to Common Stock: May 1, 1996." *Id.* Given that fact, Judge Kyle concluded that Morgan Capital was not a ten percent beneficial owner of Editek Common Stock prior to May 1, 1996, and, therefore, the conversion could not constitute a purchase matchable against Morgan Capital's later sales for purposes of Section 16(b). *See id.* at 1233-34; *Editek II* 150 F.3d at 833-34.

On appeal, the Eighth Circuit reversed the dismissal and remanded the case. Initially, the court rejected Judge Kyle's interpretation of the "within sixty days" rule and held that the "rule makes Morgan Capital a *beneficial owner* of Editek common stock on every day within sixty days of every day on which Morgan Capital had the right to acquire Editek common stock through conversion — including March 28."

Editek II, 150 F.3d at 833 (emphasis added).[2] The court declined to rule, however, on whether Morgan Capital was a "*ten percent* beneficial owner" prior to converting its Preferred Stock to Common Stock on May 1, 1996: "Of course, whether a beneficial owner under the 'within sixty days' rule is also a ten percent owner, and thus an insider subject to § 16(b), is a separate matter." *Id.*

Addressing the second ground for dismissal, the appellate court explained that there is more than one definition of the term "beneficial owner," and that the SEC passage quoted by Judge Kyle does not apply in this case:

---

2. Noting that the "within sixty days" rule was enacted under Section 13(d) — a provision which compels persons who acquire beneficial ownership of more than five percent of any class of an issuer's equity securities to report their acquisition to the issuer and the SEC — the court offered the following hypothetical fact pattern as an illustration of why the rule must be read with a forward-looking, rather than a backward-looking, purpose in mind:

> Suppose Morgan Capital's nonvoting preferred stock had been convertible beginning ninety days after issuance. Suppose further that on the first possible conversion date, the preferred stock would be worth more than five percent of Editek's voting common stock. Three days before that date, Morgan Capital sells its preferred stock to a buyer. Under the district courts's reading of the "within sixty days" rule, the buyer would have no duty to report its purchase to Editek, the stock exchange, or the SEC, even though the buyer would have a right exercisable in three days to acquire a potentially control-influencing stake in Editek's voting securities.

Editek II, 150 F.3d at 833.

The SEC is simply talking about something other than determining ten percent beneficial ownership. Again, for those other purposes, the term beneficial owner means a person who has a direct or indirect pecuniary interest in registered equity securities. *See* 17 C.F.R. § 240.16a-1(a)(2). With that in mind, and taking into consideration the quoted passage's context, the SEC's meaning becomes apparent.

The passage is lifted from a lengthy discussion of derivative securities. *See* [1990-1991 Transfer Binder] Fed.Sec.L.Rep. ¶ 84,709, at 81,258-81,266. A convertible security is a type of derivative. *See* 17 C.F.R. § 240.16a-1(c). To own a derivative security is to have an indirect pecuniary interest in the underlying security. *See id.* § 240.16a-1(a)(2)(ii)(F). But here is the crucial exception: a derivative with a floating exercise or conversion price is not a derivative security for § 16 purposes. *See id.* § 240.16a-1(c)(6); [1990-1991 Transfer Binder] Fed. Sec.L.Rep. ¶ 84,709, at 81,265. In other words, Morgan Capital, as a holder of floating-price convertible preferred stock, did not own derivative securities, did not have an indirect pecuniary interest in the underlying common stock, and accordingly (assuming Morgan Capital had no other form of pecuniary interest) was not a beneficial owner of the common stock until the conversion — for purposes other than determining ten percent beneficial ownership. It may seem odd

> that Morgan Capital both was and was not a beneficial owner of Editek common before the conversion, but the SEC has long recognized the two definitions of beneficial owner can result in different determinations of beneficial ownership. *See* Interpretive Release on Rules Applicable to Insider Reporting and Trading, Release No. 34-18,114, 4 Fed.Sec.L.Rep. (CCH) ¶ 26,062, at 19,063-7 n. 17 (Sept. 23, 1981). In sum, the quoted passage has no bearing on whether Morgan Capital was a beneficial owner for the purpose of determining ten percent beneficial ownership before the conversion. That issue is governed by the "within sixty days" rule, not the "pecuniary interest" rule.

Editek II, 150 F.3d at 834.

Finally, the Eighth Circuit identified two additional arguments raised by Defendants on appeal and addressed them in the following manner:

> Morgan Capital claims a holder of convertible preferred stock cannot "float" into and out of ten percent ownership of the underlying common stock as the price of the common stock fluctuates. The district court mentioned this issue, but did not resolve it. *See Editek*, 974 F.Supp. at 1233. At oral argument, Morgan Capital argued its stock conversion was not a "purchase" matchable against a later sale, but merely a change in the form of its beneficial ownership. In remanding this

> case, we express no opinion on these or any other issues, which we leave for the district court to address in the first instance as the parties choose to raise them.

Editek II, 150 F.3d at 834-35. Defendants now advance these two arguments, as well as a third, in support of their second motion to dismiss.

D. Ten Percent Beneficial Ownership

1. "Right to Acquire"

The Eighth Circuit's conclusion that Morgan Capital was a "beneficial owner" of Editek Common Stock before it actually converted the Preferred Stock into Common Stock on May 1, 1996, does not definitively resolve whether Plaintiff has stated a valid claim for relief under Section 16(b). As explained above in part II.B., "beneficial ownership" of any class of an issuer's equity securities does not *per se* render a shareholder subject to Section 16(b); only those shareholders who directly or beneficially own more than ten percent of any class of an issuer's equity securities are subject to the statute's restrictions. Therefore, the question squarely before the Court at this juncture is whether, consistent with the allegations in the Complaint, Plaintiff could conceivably prove that Morgan Capital beneficially owned more than ten percent of Editek Common Stock when it converted its Preferred Stock into Common Stock on May 1, 1996.

Plaintiff alleges that Morgan Capital became a "ten percent beneficial owner" of Editek Common Stock at least

as early as March 28, 1996, when, had conversion been allowed, Morgan Capital's Preferred Stock could have been converted into more than ten percent of the outstanding shares of Editek's Common Stock. In their Motion to Dismiss, Defendants initially argue that Morgan Capital could not have been a "ten percent beneficial owner" prior to converting its Preferred Stock on May 1, 1996, because the percentage of Common Stock that Morgan Capital would eventually be able to acquire in exchange for its Preferred Stock was incalculable until the date of conversion. As noted above, the Preferred Stock was convertible at a price equal to the average closing price of the Common Stock for the five trading days preceding the date notice of conversion was given to Editek. Thus, Defendants contend that Morgan Capital did not have a legally enforceable, contractual "right to acquire" any particular percentage of Editek Common Stock (as that phrase is used in the "within sixty days" rule) prior to May 1, 1996.

In advancing their interpretation of the phrase "right to acquire," Defendants rely upon three cases: *Levner v. Prince Alwaleed*, 61 F.3d 8 (2nd Cir.1995); *Allen v. Westpoint-Pepperell, Inc.*, Nos. 90 Civ. 3841, 89 Civ. 2016, 1996 WL 2004 (S.D.N.Y. Jan.3, 1996); and *Transcon Lines v. A.G. Becker Inc.*, 470 F.Supp. 356 (S.D.N.Y.1979). These cases all stand for the proposition that an investor can not be considered a "beneficial owner" of an equity security when the investor's right to acquire the security is contingent upon a future event. *See Levner*, 61 F.3d at 9 (defendant not a beneficial owner of common stock at the time of alleged short-swing transaction because preferred stock was not presently convertible); *Allen*, 1996 WL 2004, at *6 (aggressor

in a hostile takeover bid did not have a "right to acquire" the tendered stock of certain shareholders within the meaning of Rule 13d-3 where the aggressor's acquisition was contingent upon the shareholders not withdrawing their tendered stock by a particular date); and *Transcon Lines*, 470 F.Supp. at 371 (defendant not a beneficial owner of plaintiff's stock under Rule 13d-3 because his right to acquire the stock was contingent upon a future event). In *Editek II*, however, the Eighth Circuit implicitly rejected this argument by holding that Morgan Capital was a beneficial owner of Editek's Common Stock sixty days prior to March 30, 1996, despite the fact that Morgan Capital did not have a contractual right to acquire any Common Stock until that date. *Id.*, 150 F.3d at 832.

Even assuming that the decision in *Editek II* does not undermine their argument on this point, Defendants' interpretation of the phrase "right to acquire" does not entirely preclude Plaintiff from stating a valid claim under Section 16(b). Due to the retrospective nature of the conversion formula for the Preferred Stock, Defendants accurately point out that assigning Morgan Capital a precise percentage of beneficial ownership in Editek Common Stock on any day prior to March 30, 1996 (the first date upon which the Preferred Shares were convertible), is difficult. Until Morgan Capital's conversion rights had ripened, the percentage of Common Stock for which Morgan Capital would eventually be able to exchange its Preferred Stock was contingent upon future events beyond Morgan Capital's control (e.g., the closing price of the Common Stock on the five trading days preceding March 30, 1996). Thus, although Morgan Capital was a "beneficial owner" of Editek Common Stock prior to

March 30, 1996, it could not definitively be considered a "ten percent beneficial owner" — and thus an insider for purposes of Section 16(b) — during that time.

However, from March 30, 1996, onward, Morgan Capital did have a contractual right to convert its Preferred Stock to Common Stock at any time. Furthermore, the percentage of Common Stock for which Morgan Capital could exchange its Preferred Stock was no longer contingent upon future, but rather past, events. Its conversion rights having ripened, Morgan Capital could readily determine the percentage of outstanding shares of Common Stock it would receive in exchange for its Preferred Stock on any given day by simply calculating the average closing price of the Common Stock for the five previous trading days. Thus, if the trailing five-day average closing price declined sufficiently at any time between March 30, 1996, and May 1, 1996, such that Morgan Capital would have been able to acquire ten percent of the outstanding shares of Editek Common Stock on a given day, then Morgan Capital would have to be considered a "ten percent beneficial owner" of Editek's Common Stock under Section 16(b) — at least on that particular day. Although Plaintiff does not specifically allege in the Complaint that Morgan Capital had the right to acquire more than ten percent of Editek's Common Stock on any date between March 30, 1996, and May 1, 1996, proof of that fact would be consistent with the allegations set forth in the Complaint; therefore, dismissal of Plaintiff's claim on the grounds that Morgan Capital could not have been a "ten percent beneficial owner" prior to May 1, 1996, would be inappropriate. *See Goss v. City of Little Rock*, 90 F.3d 306, 308 (8th Cir.1996) (explaining that "dismissal should not be granted unless it

appears beyond a reasonable doubt that the plaintiff can prove no set of facts that would entitle relief").

2. Floating In and Out

Aside from relying by analogy upon the SEC's rule that excludes floating-price convertible securities from Section 16's definition of derivative securities (a tactic the Eighth Circuit rejected in *Editek II*), Defendants cite no authority to support their argument that holders of convertible preferred stock with a floating exercise price can not float in and out of "ten percent beneficial ownership." After March 30, 1996, if Morgan Capital could have converted its Preferred Stock into more than ten percent of the outstanding shares of Editek's Common Stock on any given day, then the presumption arises under Section 16(b) that Morgan Capital's holdings afforded it the potential for access to corporate information not available to a smaller shareholder on that day. *See Foremost-McKesson*, 423 U.S. at 253-54, 96 S.Ct. 508. At the same time, however, due to the floating conversion rate of the Preferred Stock, Morgan Capital's standing as a "ten percent beneficial owner" was potentially subject to change daily. Thus, to establish liability under Section 16(b), Plaintiff will not simply have to show that Morgan Capital could have obtained more than ten percent of Editek's Common Stock on any given day prior to May 1, 1996, but that Morgan Capital could have obtained more than ten percent of Editek's Common Stock on the day before it actually made the illicit purchase — April 30, 1996. Otherwise, Morgan Capital presumably would not have had access to inside information when it actually purchased Editek Common Stock and, therefore, would not be subject to the strictures of Section 16(b).

The fact that Morgan Capital's holdings may have hovered around Section 16's magical ten percent level does not justify Defendants' proposed blanket rule excluding all holders of floating-price convertible securities from the "ten percent beneficial owner" category. For example, if during the relevant time period leading up to conversion, Morgan Capital's shares of Preferred Stock could have been converted into a range of twenty-three to twenty-seven percent of Editek's Common Stock, rather than eight to twelve percent, then there would be little doubt that Morgan Capital should be considered an "insider" prior to the date of actual conversion in spite of the floating nature of its convertible securities. The clarity demonstrated by this example arises from the fact that Morgan Capital would at all times have had the option of acquiring possession of a substantial portion of Editek's Common Stock. In passing the Exchange Act, Congress set the "insider" bar at an arbitrary ten percent. To avoid the presumption of insider trading, Section 16 requires holders of floating-price convertible securities to be mindful of the percentage of Common Stock that they could obtain in exchange for their Preferred Stock when dealing in an issuer's securities. Although occasionally onerous (particularly when an investor's holdings hover near the ten percent mark), such monitoring is a necessary obligation to avoid being squashed by Section 16's "crude rule of thumb." *Kern County Land Co. v. Occidental Petroleum Corp.*, 411 U.S. 582, 593 n. 23, 93 S.Ct. 1736, 36 L.Ed.2d 503 (1973).

E. Purchase and Sale

Defendants' final argument for dismissal pursuant to Rule 12(b)(6) is that Plaintiff has failed to allege Morgan

Appendix B

Capital engaged in a matchable purchase and sale of Editek's Common Stock after becoming a "ten percent beneficial owner" of such stock. Defendants claim that, even assuming Morgan Capital was a "ten percent beneficial owner" of Editek's Common Stock prior to May 1, 1996, its conversion did not constitute a purchase of Common Stock, but rather a change in the form of Morgan Capital's beneficial ownership of the Common Stock from indirect to direct. The term "purchase" is broadly defined in the Exchange Act to include "any contract to buy, purchase or otherwise acquire." 15 U.S.C. § 78c(a)(13). Plaintiffs respond that Morgan Capital's conversion falls within the statute's "otherwise acquire" language.

In support of their argument, Defendants rely exclusively upon the following passage from the same discussion of derivative securities in the 1991 SEC Release cited earlier:

> The rules correspondingly recognize that, for purposes of the abuse addressed by Section 16, the exercise of a derivative security, much like the conversion of a convertible security, essentially changes the form of beneficial ownership from indirect to direct. Since the exercise represents neither the acquisition nor the disposition of a right affording the opportunity to profit, it should not be an event that is matched against another transaction in the equity securities for purposes of Section 16(b) short-swing profit recovery. . . .

1991 WL 292000, at *12. Significantly, Defendants omit from their citation the subsequent paragraph in the Release which elaborates upon the rationale for the above statement:

Appendix B

> The profit that can be realized on short-swing transactions, whether accomplished through derivative securities, the underlying equity security or a combination of both, depends upon the price of the underlying security. While the amount of the profit may vary given factors such as the time value of money and volatility of the underlying stock evidenced in the option premium, the exercise does not change the opportunity to realize a profit. As the price of the underlying common stock increases, so does the value of a call option or similar derivative security *with a fixed exercise or conversion* related to the common stock.

Id. (emphasis added). As this second portion of the passage reveals, a conversion does not constitute a "purchase" and does not present an opportunity to realize a profit only if the conversion or exercise price is fixed.

On the other hand, when the conversion price is not fixed — as is the case here — an opportunity to realize a profit presents itself where the holder of the preferred stock has access to inside information. Armed with confidential knowledge of positive developments on the horizon, the insider could convert his preferred stock when the price of the common stock is low, then sell the common stock a couple weeks or months later, after its price has risen, at a significant profit. Consequently, the SEC considers the conversion of a derivative with a floating exercise price to be a purchase matchable against sales within six months for purposes of Section 16:

Appendix B

> The rules adopted today clarify that a right with a floating exercise price is not required to be reported and will not be deemed to be acquired or purchased, for Section 16 purposes, until the purchase price of the underlying securities becomes fixed or established, which commonly occurs at exercise. Thus, *a right to purchase an equity security is deemed acquired as of the date the exercise or conversion price becomes fixed, and the acquisition, absent an exemption, would be matchable for Section 16(b) purposes with a disposition within six months of the fixing of the price.* For example, the acquisition of an option having an exercise price equal to 90 percent of the market price as of the date of exercise would be deemed to be a purchase of the underlying stock as of the date of exercise.

Id. (emphasis added). Thus, Plaintiff's allegation that Morgan Capital engaged in a matchable purchase for purposes of Section 16(b) liability by converting its floating-price Preferred Stock into Editek Common Stock on May 1, 1996, is sufficient to withstand Defendants' motion to dismiss.

Eighth Circuit case law also supports such a conclusion. In *Petteys v. Butler*, 367 F.2d at 535, the court explained that when determining whether a particular transaction should be considered a "purchase" under the Exchange Act, "each case must be examined on its own particular facts." The court went on to set forth the following test for use in the individualized analysis:

> If, from an examination of the particular facts, a transaction is of a kind that can possibly lend itself to the speculation encompassed by § 16(b) and falls within the broad definition of "purchase" and "sale", it will be so defined. However, if an examination of the facts indicates that there is no possibility of abuse, there is no need to apply a § 16(b) label to the transaction.

Id. Thus, if Morgan Capital's conversion of Preferred Stock into Editek's Common Stock could possibly have lent itself to speculation, then the conversion must be considered a "purchase" under the Exchange Act.

As explained above, the possibility of speculative abuse in Morgan Capital's conversion was high. Beginning March 30, 1996, Morgan Capital had control over when to convert its Preferred Stock into Common Stock and, assuming it could have converted its Preferred Stock into more than ten percent of the outstanding shares of Common Stock prior to May 1, 1996, Morgan Capital presumably was in possession of inside information at the time it chose to convert its stock. Therefore, consistent with the Act, the 1991 SEC Release, and Eighth Circuit precedent, Morgan Capital's alleged conversion of its Preferred Stock into Editek's Common Stock on May 1, 1996, constituted a "purchase" of the Common Stock under Section 16(b).

III. DEFENDANTS' 12(b)(3) MOTION

Rule 12 also provides that a defendant may move to dismiss a complaint for improper venue. Fed.R.Civ.P.

12(b)(3). Venue for Section 16(b) claims is governed by Section 27 of the Exchange Act. Section 27 provides in relevant part:

> Any suit or action to enforce any liability or duty created by this chapter or the rules and regulations thereunder ... may be brought in [the district wherein any act or transaction constituting the violation occurred] or in the district wherein the defendant is found or is an inhabitant or transacts business ...

15 U.S.C. § 78aa. The term "transacts business" has been liberally interpreted to constitute any transaction of business within the district. *See, e.g., Abbey v. Henzel*, 731 F.Supp. 1431, 1435 (E.D.Mo.1990) (telephoning, sending mail, and faxing documents to plaintiff in forum state sufficient to establish venue); *Wilson v. Lamb*, 632 F.Supp. 1442, 1446-47 (W.D.Ark.1986) (mailing important documents to forum to be executed by plaintiffs is sufficient to establish venue). "Venue is proper as to all defendants if one act in furtherance of the alleged unlawful scheme is done in the forum district." *Stewart v. Fry*, 575 F.Supp. 753, 755 (E.D.Mo.1983). *See also Bourassa v. Desrochers*, 938 F.2d 1056, 1057 (9th Cir.1991) (telephone call by defendant to plaintiff in forum sufficient to establish venue); and *Steinberg & Lyman v. Takacs*, 690 F.Supp. 263, 267 (S.D.N.Y.1988) (any not-trivial act in forum district which helps to accomplish securities law violation, including phone call made by defendant to forum, is sufficient to establish venue).

Defendants Alex and David Bistricer initiated numerous telephone calls to Plaintiff's Vice President of Finance/Chief

Financial Officer, Peter J. Heath ("Heath"), during April and May 1996. Heath Aff. ¶¶ 3, 4. On the basis of these phone calls, Morgan Capital allegedly decided to purchase and sell Editek Common Stock in May and June 1996 in violation of Section 16(b). Assuming the allegations to be true, Defendants transacted sufficient business within Minnesota to establish venue here for Plaintiff's claim. Accordingly, Defendants' Rule 12(b)(3) motion is denied.

IV. PLAINTIFF'S MOTION FOR PARTIAL SUMMARY JUDGMENT

A. Factual Background[3]

Editek and Morgan Capital entered into a Private Securities Subscription Agreement ("Agreement") on January 30, 1996, pursuant to which Morgan Capital purchased three shares of nonvoting Editek Preferred Stock for $150,000. Block Aff. Ex. 1. The Preferred Stock was convertible into Editek Common Stock beginning on March 30, 1996. *Id.* The number of shares of Common Stock into which the Preferred Stock could be converted was a function of the average closing bid price of Editek Common Stock for the five trading day period preceding the date Morgan Capital gave notice of conversion to Editek. *Id.* In other words, as the trading price of Editek's Common Stock declined, the number of shares of Common Stock into which Morgan Capital's Preferred Stock could be converted concomitantly increased.

---

3. Because Plaintiff is moving for summary judgment, the facts are set forth in a light most favorable to Defendants.

Appendix B

The price of Editek's Common Stock steadily declined throughout March and April 1996. Heath Aff. Ex. B. As a result, on any day between April 9 and April 30, 1996, the price was sufficiently low that had Morgan Capital elected to convert its Preferred Stock, it would have received more than ten percent of the outstanding shares of Editek's Common Stock. *Id.* at ¶ 10, Ex. E. During this time interval, Defendants David and Alex Bistricer, officers and controlling principals of Morgan Capital's day-to-day business affairs, had weekly telephone conversations with Editek management. *Id.* at ¶ 3. Approximately one-half of these calls were placed by Alex Bistricer to Editek's Minnesota office. *Id.* The topics discussed included Editek's declining stock price and its implications for Morgan Capital's conversion rights. *Id.* at ¶ 4. Editek also responded to a range of questions from the Bistricers regarding the company's underlying business. *Id.*

On May 1, 1996, Morgan Capital converted its Preferred Stock into 4,584,795 shares of Common Stock. Braun Aff. ¶ 4. At the time of conversion, the shares received represented more than ten percent of the outstanding shares of Editek Common Stock. *Id.* at ¶ 4, Ex. C. Following the conversion, the Bistricers' weekly telephone conversations with Editek continued throughout May 1996. Heath Aff. ¶¶ 3, 4. In several trades during May and June 1996, Morgan Capital sold 688,272 shares of Editek Common Stock for a total of $919,269.39. Braun Aff. ¶¶ 2, 3, Exs. A, B. Morgan Capital's basis in the shares it sold was $367,812.55.[4] As a result of

4. The effective conversion price was $.5344 per share. *See* Braun Aff. ¶ 6. Therefore, at a price of $.5344 per share, Morgan Capital's basis in the 688,272 shares of Editek Common Stock it sold during May and June 1996 was $367,812.55.

these transactions, Morgan Capital realized total profits of $551,456.84.[5]

B. Section 16(b) Violation

Plaintiff seeks entry of summary judgment against Morgan Capital in the amount of $551,456.84. In response, Defendants simply reiterate the arguments raised in their motion to dismiss: 1) that Morgan Capital was not a "ten percent beneficial owner" of Editek's Common Stock until conversion of the Preferred Stock on May 1, 1996; and 2) even if Morgan Capital was a "ten percent beneficial owner" of Editek's Common Stock prior to May 1, 1996, conversion of its Preferred Stock into Common Stock did not constitute a "purchase" under Section 16(b). As explained above, these arguments are precluded by the Eighth Circuit's decision in Editek II, as well as the applicable statutory and case law.

Morgan Capital became a "ten percent beneficial owner" of Editek Common Stock on April 9, 1996, and remained such through at least June 30, 1996.[6] By exercising the option

---

5. Morgan Capital owned more than ten percent of Editek's Common Stock on every day between May 1, 1996, and June 30, 1996. *See* Braun Aff. ¶ 7. Morgan Capital filed a Schedule 13D with the SEC on May 17, 1996, on which it declared that it owned 18.2 percent of the outstanding Common Stock as of May 9, 1996. *Id.* at Ex. C. Morgan Capital filed an Amended Schedule 13D on July 9, 1996, on which it declared that it owned 15.44 percent of the outstanding Common Stock as of July 3, 1996. *Id.* at Ex. D.

6. *See supra* note 5.

to convert its Preferred Stock into Common Stock on May 1, 1996, Morgan Capital fixed the conversion price and thereby engaged in a matchable purchase of Editek's Common Stock for Section 16(b) liability purposes. Over the next two months, Morgan Capital sold a portion of the stock it purchased on May 1, 1996, for a total profit of $551,456.84. Because these transactions constitute "short-swing" insider trading in violation of Section 16(b), Editek is entitled to recover the full profit realized by Morgan Capital. See *Park & Tilford v. Schulte*, 160 F.2d 984, 987 (2nd Cir.1947), cert. denied, 332 U.S. 761, 68 S.Ct. 64, 92 L.Ed. 347 (1947) (holding that the purpose of the Exchange Act is "to squeeze all possible profits out of [insider] stock transactions, and thus to establish a standard so high as to prevent any conflict between the selfish interest of a fiduciary officer, director, or stockholder and the faithful performance of his duty"). Plaintiff's motion is therefore granted.

V. CONCLUSION

Based upon the foregoing, and all of the files, records and proceedings herein, **IT IS HEREBY ORDERED** that:

1. Defendant's Motion to Dismiss [Docket No. 34] is **DENIED.**

2. Plaintiff's Motion for Partial Summary Judgment [Docket No. 39] is **GRANTED.**

3. Defendant Morgan Capital shall pay damages to Plaintiff in the amount of $551,456.84.

APPENDIX C — OPINION OF THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT DATED JULY 24, 1998

UNITED STATES COURT OF APPEALS
EIGHTH CIRCUIT

No. 97-3400

EDITEK, INC.,

Appellant,

v.

MORGAN CAPITAL, L.L.C.; Alex Bistricer; David Bistricer,

Appellees.

Submitted May 15, 1998.

Decided July 24, 1998.

* * *

Before RICHARD S. ARNOLD and FAGG, Circuit Judges, and BOGUE,* District Judge.

---

*The Honorable Andrew W. Bogue, United States District Judge for the District of South Dakota, sitting by designation.

Appendix C

FAGG, Circuit Judge.

Editek, Inc. brought this lawsuit against Morgan Capital, L.L.C. and its officers, Alex and David Bistricer (collectively Morgan Capital), under § 16(b) of the Securities Exchange Act of 1934 (the 1934 Act), 15 U.S.C. § 78p(b), to recover claimed short-swing profits. Section 16(b) applies only to corporate insiders: directors, officers, and beneficial owners of more than ten percent of a corporation's registered equity securities (ten percent beneficial owners). Only the ten percent beneficial owner category is involved here. Based on a misreading of the applicable rules, the district court concluded Editek's complaint failed to allege facts that, if proven, would make Morgan Capital a beneficial owner at the legally required time. On that basis, the district court granted Morgan Capital's motion to dismiss under Federal Rule of Civil Procedure 12(b)(6). Editek appeals. We reverse and remand for further proceedings.

The purpose of § 16(b) is to prevent corporate insiders from exploiting inside information to turn a quick profit trading in their company's stock. *See* 15 U.S.C. § 78p(b) (1994); *Foremost-McKesson, Inc. v. Provident Sec. Co.*, 423 U.S. 232, 234, 96 S.Ct. 508, 46 L.Ed.2d 464 (1976). To achieve this purpose, Congress enacted a flat rule: any profit realized by an insider "from any purchase and sale, or any sale and purchase, of any equity security of such issuer ... within any period of less than six months, ... shall inure to and be recoverable by the issuer." 15 U.S.C. § 78p(b). A further provision of the statute applies only to ten percent beneficial owners. To be liable under § 16(b), a ten percent beneficial owner must have been such "both at the time of

the purchase and sale, or the sale and purchase, of the security involved." *Id.* As the Supreme Court has made clear, to be a ten percent beneficial owner "at the time of the purchase," a person must have already become a ten percent beneficial owner before the purchase. *See Foremost-McKesson*, 423 U.S. at 249-50, 96 S.Ct. 508. Because an owner below the statutory threshold presumptively lacks access to inside information, the acquisition that takes a buyer above ten percent ownership does not count as a "purchase" matchable against a later sale for § 16(b) purposes. *See id.* at 253-54 & n. 28, 96 S.Ct. 508; 17 C.F.R. § 240.16a-2(c) (1997).

With these principles in mind, we set forth the relevant background, accepting as true the facts asserted in Editek's complaint and construing the complaint in the light most favorable to Editek. *See Doe v. Norwest Bank Minnesota, N.A.*, 107 F.3d 1297, 1303-04 (8th Cir.1997). Around February 1, 1996, Editek issued shares of preferred stock, convertible into Editek common stock, and sold some shares to Morgan Capital in a private placement. Editek acknowledges in its brief that the preferred shares were nonvoting. Thus, only the underlying common stock, not the preferred stock, counts for purposes of determining Morgan Capital's ten percent beneficial ownership status. *See* Ownership Reports and Trading By Officers, Directors and Principal Security Holders, Exchange Act Release No. 28,869, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,709, at 81,252 n. 36 (Feb. 8, 1991). Morgan Capital had the right to convert its preferred stock into Editek common stock beginning sixty days after issuance of the preferred stock. Despite the complaint's vagueness about the issuance date, the parties now agree March 30 marked the

start of the conversion period. The conversion price floated: the number of common shares Morgan Capital would acquire at conversion would be based on the average closing price of Editek common stock for the five trading days just before the conversion date. In other words, as the price of Editek common stock dropped, the number of common shares Morgan Capital's preferred stock would buy increased. Around March 28, 1996, the price of Editek common stock fell low enough that Morgan Capital's preferred stock was worth more than ten percent of the outstanding shares of Editek's common stock. On May 1, 1996, Morgan Capital received more than ten percent of Editek's outstanding common stock when it exercised its conversion right. According to Editek, this conversion was the "purchase" matchable against later sales for § 16(b) purposes. Later that month and the next, Morgan Capital sold part of its newly acquired Editek common stock, realizing a profit of at least $500,000.

We review de novo a Rule 12(b)(6) dismissal, affirming "only if 'it appears beyond a doubt that the plaintiff can prove no set of facts which would entitle the plaintiff to relief.' " *Doe*, 107 F.3d at 1304 (quoting *Coleman v. Watt*, 40 F.3d 255, 258 (8th Cir.1994)). In other words, dismissal under Rule 12(b)(6) is proper "only if it is clear that no relief can be granted under any set of facts that could be proved consistent with the allegations." *Frey v. City of Herculaneum*, 44 F.3d 667, 671 (8th Cir.1995) (internal quotations omitted). Applying this standard, the district court concluded Editek could not show that Morgan Capital was a beneficial owner of Editek common stock before the conversion. In the district court's view, Editek's complaint alleged a transaction that

made Morgan Capital a ten percent beneficial owner — the conversion itself — followed by profitable sales. Because such conduct is not unlawful, the district court dismissed Editek's complaint. *See Editek, Inc. v. Morgan Capital, L.L.C.*, 974 F.Supp. 1229, 1234 (D.Minn.1997).

The district court's decision turns entirely on the term *beneficial owner*, which the governing regulations define in two different ways. For purposes other than determining ten percent beneficial ownership, "the term *beneficial owner* shall mean any person who .. . has or shares a direct or indirect pecuniary interest in the equity securities. . . ." 17 C.F.R. § 240.16a-1(a)(2). For the purpose of determining ten percent beneficial ownership, the meaning of *beneficial owner* is a bit more complicated. Rule 16a-1 states:

> Solely for purposes of determining whether a person is a beneficial owner of more than ten percent of any class of equity securities registered pursuant to section 12 of the [1934] Act, the term "beneficial owner" shall mean any person who is deemed a beneficial owner pursuant to section 13(d) of the Act and the rules thereunder .. ..

Id. § 240.16a-1(a)(1). Turning to the rules under § 13(d) of the 1934 Act, we find two relevant provisions. First, a beneficial owner of a security includes any person who has voting power or investment power in relation to the security. *See id.* § 240.13d-3(a). More importantly for our purposes, "[a] person shall be deemed to be the beneficial owner of a security . . . if that person has the right to acquire beneficial ownership of such security, as defined in Rule 13d-3(a)

(§ 240.13d-3(a)) within sixty days . . . (B) through the conversion of a security. . . ." *Id.* § 240.13d-3(d)(1)(i)(B). We will refer to this last definition as the "within sixty days" rule.

The district court gave two explanations why it concluded Editek could not prove any set of facts that would make Morgan Capital a beneficial owner before the conversion. The first is based on a misunderstanding of the "within sixty days" rule. From the way the district court applied the rule, the court must have read it as saying the right to acquire beneficial ownership within sixty days through a conversion means the right to acquire this ownership within sixty days of the issuance of the convertible securities. Reading the rule the same way, Editek argued Morgan Capital was a beneficial owner of Editek common stock before the conversion "because [Morgan Capital] had a right to acquire beneficial ownership of Editek Common Stock within sixty days after issuance of [the] Preferred Stock." *Editek*, 974 F.Supp. at 1232 (emphasis and internal quotations omitted). According to Editek's complaint, however, the preferred shares were convertible, not *within* sixty days of issuance, but beginning sixty days *after* issuance — that is, on the sixtieth day following the date of issuance. *See id.* at 1233. The district court thus concluded Morgan Capital could not be proven a beneficial owner before the conversion under the "within sixty days" rule. *See id.* The district court rejected Editek's contention that Morgan Capital was a beneficial owner on March 28 because the conversion right was not immediately exercisable on that date. *See id.*

In our view, the district court's interpretation of the "within sixty days" rule is at odds with the rule's purpose.

Appendix C

Section 13(d) of the 1934 Act, under which the rule was enacted, requires persons who acquire beneficial ownership of more than five percent of certain classes of securities to report their purchase to the issuer, to the exchanges where the securities are traded, and to the Securities and Exchange Commission (SEC). *See* 15 U.S.C. § 78m(d)(1) (1994). The purpose of this requirement is to alert the issuing company, the market, and the SEC to transactions that might change or influence the control of the company. *See id.* § 78m(d)(6)(D). The "within sixty days" rule should be read with this forward-looking purpose in mind. An illustration will show why. Suppose Morgan Capital's nonvoting preferred stock had been convertible beginning ninety days after issuance. Suppose further that on the first possible conversion date, the preferred stock would be worth more than five percent of Editek's voting common stock. Three days before that date, Morgan Capital sells its preferred stock to a buyer. Under the district court's reading of the "within sixty days" rule, the buyer would have no duty to report its purchase to Editek, the stock exchange, or the SEC, even though the buyer would have a right exercisable in three days to acquire a potentially control-influencing stake in Editek's voting securities.

We think the "within sixty days" rule means just what it says. The SEC does also:

> The Commission is . . . mindful that as the point in time [at] which the right to acquire may come to fruition is extended into the future the . . . right's ability to influence control is correspondingly attenuated. When sixty days or

> less are left until the right to acquire may be exercised, the Commission believes that the ability of the holder of such right to effect control is sufficient to warrant the imposition of an obligation to file under Rule 13d-1.

Filing and Disclosure Requirements Relating to Beneficial Ownership, Exchange Act Release No. 14,692, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,571, at 80,310 (Apr. 21, 1978). Applied here, the "within sixty days" rule makes Morgan Capital a beneficial owner of Editek common stock on every day within sixty days of every day on which Morgan Capital had the right to acquire Editek common stock through conversion — including March 28. Of course, whether a beneficial owner under the "within sixty days" rule is also a ten percent owner, and thus an insider subject to § 16(b), is a separate matter.

We turn next to the second basis for the district court's conclusion. Noting that the conversion price floated, the district court found relevant the following passage from an SEC release:

> [A] right with a floating exercise price ... will not be deemed to be acquired or purchased, for Section 16 purposes, until the purchase price of the underlying securities becomes fixed or established, which commonly occurs at exercise. Thus, a right to purchase an equity security is deemed acquired as of the date the exercise or conversion price becomes fixed, and the acquisition, absent an exemption, would be

> matchable for Section 16(b) pposes with a disposition within six months of t fixing of the price.

[1990-1991 Transfer Binder] Fed. Sec.. Rep. ¶ 84,709, at 81,265. As we have just explained, unr the "within sixty days" rule Morgan Capital's claimed neficial ownership before the conversion depended on i having a right to acquire such ownership within a statedme. Based on the quoted passage, the district court concled Morgan Capital did not gain the right referred to in th within sixty days" rule until the conversion itself, so it cld not have been a beneficial owner before the conversio *See Editek*, 974 F.Supp. at 1233.

Although this conclusion follows ogically from the quoted passage, it contradicts the conclion dictated by the "within sixty days" rule itself, un which Editek's complaint would make Morgan Capita beneficial owner of Editek common stock well before e conversion date. The quoted language is not at odds w the "within sixty days" rule, however. The SEC is sply talking about something other than determining tepercent beneficial ownership. Again, for those other rposes, the term *beneficial owner* means a person who h a direct or indirect pecuniary interest in registered equit ecurities. *See* 17 C.F.R. § 240.16a-1(a)(2). With that in nd, and taking into consideration the quoted passage's ntext, the SEC's meaning becomes apparent.

The passage is lifted from a le hy discussion of derivative securities. *See* [1990-1991 T nsfer Binder] Fed.

Sec. L. Rep. ¶ 84,709, at 81,258-81,266. A convertible security is a type of derivative. *See* 17 C.F.R. § 240.16a-1(c). To own a derivative security is to have an indirect pecuniary interest in the underlying security. *See id.* § 240.16a-1(a)(2)(ii)(F). But here is the crucial exception: a derivative with a floating exercise or conversion price is not a derivative security for § 16 purposes. *See id.* § 240.16a-1(c)(6); [1990-1991 Transfer Binder] Fed. Sec. L. Rep. ¶ 84,709, at 81,265. In other words, Morgan Capital, as a holder of floating-price convertible preferred stock, did not own derivative securities, did not have an indirect pecuniary interest in the underlying common stock, and accordingly (assuming Morgan Capital had no other form of pecuniary interest) was not a beneficial owner of the common stock until the conversion — for purposes *other* than determining ten percent beneficial ownership. It may seem odd that Morgan Capital both was and was not a beneficial owner of Editek common before the conversion, but the SEC has long recognized the two definitions of *beneficial owner* can result in different determinations of beneficial ownership. *See* Interpretive Release on Rules Applicable to Insider Reporting and Trading, Release No. 34-18,114, 4 Fed. Sec. L. Rep. (CCH) ¶ 26,062, at 19,063-7 n. 17 (Sept. 23, 1981). In sum, the quoted passage has no bearing on whether Morgan Capital was a beneficial owner for the purpose of determining ten percent beneficial ownership before the conversion. That issue is governed by the "within sixty days" rule, not the "pecuniary interest" rule.

The district court held Editek's complaint failed to state a claim based solely on the conclusion that Morgan Capital was not a beneficial owner before the conversion. That conclusion was incorrect, so the district court's ruling cannot

stand. On appeal, Morgan Capital has raised two other legal challenges to Editek's complaint. Morgan Capital claims a holder of convertible preferred stock cannot "float" into and out of ten percent ownership of the underlying common stock as the price of the common stock fluctuates. The district court mentioned this issue, but did not resolve it. *See Editek*, 974 F.Supp. at 1233. At oral argument, Morgan Capital argued its stock conversion was not a "purchase" matchable against a later sale, but merely a change in the form of its beneficial ownership. In remanding this case, we express no opinion on these or any other issues, which we leave for the district court to address in the first instance as the parties choose to raise them.

We reverse the judgment of the district court, vacate the district court's order dismissing with prejudice Editek's complaint under Federal Rule of Civil Procedure 12(b)(6), and remand for further proceedings consistent with this opinion.

APPENDIX D — MEMORANDUM OPINION AND ORDER OF THE UNITED STATES DISTRICT COURT FOR THE DISTRICT OF MINNESOTA DATED AUGUST 4, 1997

UNITED STATES DISTRICT COURT
DISTRICT OF MINNESOTA

Civ. No. 97-253/RHK/JMM

EDITEK, INC.,

Plaintiff,

v.

MORGAN CAPITAL, L.L.C., Alex Bistricer and David Bistricer,

Defendants.

Aug. 4, 1997.

* * *

MEMORANDUM OPINION AND ORDER

KYLE, District Judge.

Introduction

Plaintiff Editek, Inc. ("Editek") brings this action against Defendants Morgan Capital, L.L.C. ("Morgan Capital"), and Alex and David Bistricer ("the Bistricers") (collectively

"Defendants"), alleging violation of Section 16(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78p(b), in connection with Defendants' sale of Editek stock. This matter is before the Court on Defendants' Motion to Dismiss the Complaint for Improper Venue, pursuant to Fed.R.Civ.P. 12(b)(3), for Failure to State a Claim Upon Which Relief May Be Granted, pursuant to Fed.R.Civ.P. 12(b)(6), and for Failure to Comply with Rule 23.1, pursuant to Fed.R.Civ.P. 41(b). For the reasons set forth below, this Court will grant Defendants' Motion to Dismiss for Failure to State a Claim Upon Which Relief May Be Granted, and will deny Defendants' other Motions as moot.

Background

I. *The Parties*

Editek is a Delaware Corporation primarily engaged in the business of medical and chemical testing. (Compl. ¶ 2.) Morgan Capital is a limited liability corporation with offices in Brooklyn, New York. (*Id.* ¶ 3.) On July 2, 1996, the Bistricers became members of the Board of Directors of Editek. (*Id.* ¶ 19.)

II. *The Editek Stock*

On February 1, 1996, Editek issued shares of its Convertible Preferred Stock ("Preferred Stock") in an offering conducted under Regulation D of the Securities Act of 1933 ("the Offering"). (Compl. ¶ 11.) "Each Preferred Share was convertible at the option of the holder at a price equal to the average closing price of the shares of Common

Stock of Editek (the "Common Stock") for the five trading day period preceding the date" the holder gave notice of conversion to Editek. (*Id.* ¶ 12.) This right to convert was exercisable sixty days *after* the issuance of the shares. (*See id.*; Block Aff. Ex. 1 at 4(c) (Certificate of Designations of Preferred Stock of Editek) ("The period commencing the sixtieth (60th) day following the First Issuance Date and ending on the Conversion Termination Date shall be referred to as the 'Conversion Period.' ").)

Morgan Capital purchased Preferred Stock in the Offering. (Compl. ¶ 13.) The shares of Common Stock that it would have received upon conversion of its Preferred Stock at the time of purchase would have been less than ten percent of the outstanding shares of Editek's Common Stock. (*Id.*)

On May 1, 1996, Morgan Capital converted all of its Preferred Stock and received shares of Editek's Common Stock representing more than ten percent of the outstanding shares of Common Stock. (Compl. ¶ 15.) Shortly thereafter, Morgan Capital filed the appropriate forms with the SEC to reflect this fact. (*See id.* ¶ 16.)

In May and June of 1996, Morgan Capital sold a portion of its shares of Common Stock. (Compl. ¶ 17.) Defendants realized at least $500,000 in profits as a result of these sales. (*Id.* ¶ 18.) Editek alleges that this conduct violated federal securities laws and seeks disgorgement of Defendants' profits, an accounting of Defendants' profits, and costs and attorneys' fees. (*See* Compl. at 5.)

Appendix D

Discussion

The Court begins with Defendants' Motion under Fed.R.Civ.P. 12(b)(6).

I. *Standard of Review*

When reviewing a motion to dismiss under Rule 12(b)(6) of the Federal Rules of Civil Procedure, the Court accepts as true the material facts alleged in the complaint and considers the allegations therein in the light most favorable to the non-movant. *Scheuer v. Rhodes*, 416 U.S. 232, 236, 94 S.Ct. 1683, 1686, 40 L.Ed.2d 90 (1974). The court should not grant the motion unless it appears "beyond a doubt that the plaintiff could prove no set of facts which would entitle" her to relief. *Roe v. Norwest Bank*, 107 F.3d 1297, 1304 (8th Cir.1997); *see also Coleman v. Watt*, 40 F.3d 255, 258 (8th Cir.1994); *United States v. Aceto Agric. Chem. Corp.*, 872 F.2d 1373, 1376 (8th Cir.1989). The issue is not whether Editek will ultimately prevail, but whether it is entitled to offer evidence in support of its claim. *Aceto*, 872 F.2d at 1376 (citing *Scheuer*, 416 U.S. at 236, 94 S.Ct. at 1686).

When assessing a motion to dismiss under Rule 12(b)(6), this Court may consider materials attached to the complaint as exhibits, *Peter v. Johnson*, 958 F.Supp. 1383, 1389 (D.Minn.1997) (citing *County of St. Charles v. Missouri Family Health Council*, 107 F.3d 682 (8th Cir.1997)), or referred to in the Complaint, if those documents are "integral to the complaint." *See Brogren v. Pohlad*, 933 F.Supp. 793, 798 (D.Minn.1995) (reviewing documents referred to, but not attached to, the complaint when deciding a motion to

dismiss a securities case). If the Court considers additional materials, the motion to dismiss must be treated as a motion for summary judgment. *Peter*, 958 F.Supp. at 1389; Fed.R.Civ.P. 56.

In deciding this Motion to Dismiss, this Court has considered only the Complaint itself, and documents referred to within the Complaint. Therefore, the Court will not convert this Motion to one for Summary Judgment.

II. *Section 16(b)*

Editek brings this action pursuant to Section 16(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78p(b), which provides, in relevant part:

> For the purpose of preventing the unfair use of information which may have been obtained by [a] beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months. . . .

15 U.S.C. § 78p(b) ("Section 16(b)"). Section 78p(a) defines "beneficial owner" for these purposes as "[e]very person who is directly or indirectly the beneficial owner of more than 10 per centum of any class of equity security (other than an exempted security) which is registered pursuant to section 781" of the Act. *Id.* § 78p(a); *see also* 17 C.F.R. § 240.16a-1 ("Terms defined in this rule shall apply solely to section 16 of the Act and the rules thereunder. These terms shall not be limited to section 16(a) of the Act but also shall apply to all other subsections under section 16 of the Act.")

Section 16(b) was enacted to prevent the use of inside information which one could obtain because of a relationship to the corporation. *See* 15 U.S.C. § 78p(b); *Schaffer v. Dickstein & Co.*, No. 95 Civ. 7934(BSJ), 1996 WL 148335, at *2 (S.D.N.Y.1996) (recognizing that stated purpose of Section 16(b) is to prevent use of inside information). Beneficial owners are considered "insiders" because "the size of their holdings afford[s] the potential for access to corporate information." *Foremost-McKesson v. Provident Secs. Co.*, 423 U.S. 232, 253, 96 S.Ct. 508, 520, 46 L.Ed.2d 464 (1976).

The statute makes explicit that it "shall *not* be construed to cover any transaction where such beneficial owner was not such *both at the time of the purchase and sale, or the sale and purchase*, of the security involved." 15 U.S.C. § 78p(b) (emphasis added). The United States Supreme Court has clarified that the actual purchase which makes a company or person a beneficial owner does not constitute one of the requisite purchases for liability under Section 16(b). *See Foremost-McKesson*, 423 U.S. at 253-54, 96 S.Ct. at 520-21. The Court explained that it would be inconsistent with the purpose of the statute

> to impose liability on the basis of a purchase made when the percentage of stock ownership requisite to insider status had not been acquired. To be sure, the possibility does exist that one who becomes a beneficial owner by purchase will sell on the basis of information attained by virtue of his newly acquired holdings. But that purchase itself was not one posing dangers that Congress considered intolerable, since it was made when the purchaser owned no shares or less than the percentage deemed necessary to make him an insider.

Id., 423 U.S. at 254, 96 S.Ct. at 521; *see also* 17 C.F.R. § 240.16a-2(b)(c) ("The transaction that results in a person becoming a ten percent beneficial owner is not subject to section 16 of the Act unless the person is otherwise subject to section 16 of the Act.") Thus, having *already attained* the status of beneficial owner, the person or entity must engage in a sale and purchase (or purchase and sale) within six months to violate Section 16(b). The time at which Morgan Capital became a beneficial owner is the heart of the parties' dispute.

III. *When Morgan Capital Became a Beneficial Owner*

Editek's Complaint alleges as follows:

> 14. As a result of a decline in the price of the Common Stock, on around March 28, 1996, Morgan Capital had the right to acquire within 60 days more than ten percent of the outstanding shares of the Common Stock based on the prevailing price for the Common Stock.

> 15. On May 1, 1996, Morgan Capital converted all of the Preferred Shares held by it and received shares of Common Stock representing more than ten percent of the outstanding shares of Common Stock.
>
> 16. In May or June 1996, Morgan Capital filed with the S.E.C. a Form 3 and a Form 13(d) to reflect the fact that it was a beneficial owner of more than ten percent of the outstanding shares of Common Stock.
>
> 17. On five different dates in May and June 1996, Morgan Capital sold a portion of its shares of Common Stock. . . .

(Compl. ¶¶ 14-17.)

Editek argues that Morgan Capital became a beneficial owner for purposes of Section 16(b) on March 28, 1996, when, as a result of the declining price of Editek Common Stock, it had the *right* to obtain more than ten percent of the outstanding stock by converting its Preferred Stock. Thus, Editek maintains that Morgan Capital was a beneficial-owner when it actually exercised its conversion and purchased the Common Stock on May 1, making the May and June sales illegal under Section 16(b). (*See* Pl.'s Mem. in Opp'n to Defs.' Mot. for Summ. J. at 11-13.) ("Pl.'s Mem.")

Morgan Capital responds that it did not become a beneficial owner until after it exercised its conversion rights on May 1. (*See* Defs.' Mem. in Supp. of Mot. to Dismiss the

Compl. at 10.) Thus, the Complaint only alleges that Morgan Capital engaged in the *sale* of stock while a beneficial owner, not the sale *and* purchase required under Section 16(b). (*See* Defs.' Reply Mem. at 11-15).

Editek bases its argument on the following language from the Exchange Act Rules:

> Terms defined under this rule shall apply solely to section 16 of the Act and the rules thereunder. These terms shall not be limited to section 16(a) of the Act but also shall apply to all other subsections under section 16 of the Act.
>
> (a) The term beneficial owner shall have the following applications:
>
> (1) Solely for the purposes of determining whether a person is a beneficial owner of more than ten percent of *any class of equity securities* registered pursuant to section 12 of the Act, the term *"beneficial owner" shall mean any person who is deemed a beneficial owner pursuant to section 13(d) of the Act and the rules thereunder* . . .

17 C.F.R. § 240.1.16a-1(a)(1) (emphasis added). Section 13(d) states:

> For the purpose of sections 13(d) and 13(g) of the Act a beneficial owner of a security includes any person who, directly, or indirectly, through any

> contract, arrangement, understanding, relationship, or otherwise has or shares:
>
> (1) Voting power which includes the power to vote, or to direct the voting of, such security; and/or,
>
> (2) Investment power which includes the power to dispose, or to direct the disposition of, such security.
>
> . . .

Id. § 240.13d-3(a)(1) & (2). The Rule further states that

> a person shall be deemed to be the beneficial owner of a security, subject to the provisions of paragraph (b) of this rule, *if that person has the right to acquire beneficial ownership of such security*, as defined in Rule 13d-3(a) . . . *within sixty days*, including but not limited to any right to acquire . . . [t]hrough the conversion of a security.

Id. § 240.13d-3(b) ("the ownership provision"). Pursuant to the ownership provision, Editek contends that Morgan Capital was a beneficial owner as of March 28, 1996.

In its Memorandum to this Court, Editek states that "it has never claimed that Morgan Capital was a ten percent beneficial owner of *Preferred Stock*. Editek simply argues that Morgan Capital was a beneficial owner because it had a

right to acquire beneficial ownership of Editek Common Stock within sixty days after issuance of Preferred Stock through the phase-in of its conversion right and the prevailing stock price for Editek's Common Stock."[1] (Pl.'s Mem. at 13-14) (emphasis added). The Court disagrees.

"Sixty-Day Rule"

Paragraph 12 of the Complaint plainly states: "The right to convert the Preferred Shares was exercisable 60 days *after* issuance of the shares." (Compl. ¶ 12.) Moreover, the stock agreement itself states that the holder "shall have no right to convert the stock" until the beginning of the Conversion Period, which is defined as the "period commencing on the sixtieth (60th) day following the First Issuance Date." (Block Aff. Ex. 4.) Thus, there was only one day — the sixtieth day — on which Morgan Capital could actually convert its Preferred Stock *within* sixty days of issuance. Editek's Complaint contains no allegation that the price of Common Stock on the sixtieth day was low enough that Morgan Capital could have become an owner often percent of the shares of Editek's Common Stock by converting its Preferred Stock on that day. In fact, the Complaint alleges only one date, March 28, 1996, on which the price of the Common Stock

---

1. Editek presumably makes this argument because ownership of the Preferred Stock itself, which is non-voting, would undisputedly fail to confer beneficial ownership status on Defendants. *See, e.g.*, 17 C.F.R. § 240.13d-1 (stating that the term "equity security" for these purposes "shall not include securities of a class of non-voting securities.") Thus, Editek turns the Court's focus away from the characteristics of the Preferred Stock itself, and toward the access to Common Stock it provides its holder.

was low enough that Morgan Capital conversion of its Preferred Stock would actually have resu d in its ten percent ownership of Common Stock. On that da however, Morgan Capital's Preferred Stock was still not ercisable because the Conversion Period had not yet star

Editek's theory has Morgan Capita loating in and out of beneficial-ownership status depenc g on the price of Common Stock. Even if the Court felt th aw supported such a scenario, the Complaint is simply d oid of allegations consistent with it. Editek has crafted a rgument in which it has one day to comply with the requi ents of both Rule 13d and the terms of the Preferred Sto itself: the sixtieth day. There is no mention of this day n the Complaint. Accordingly, the Complaint has not all ed facts which, if proven, could demonstrate that Morgan apital had a right to acquire more than ten percent of the standing shares of Common Stock.

"Floating Exercise Pri..

Irrespective of the problems with e sixty-day rule, Editek still could not satisfy the owner p provision based on the facts alleged in the Complaint.

The Preferred Stock did not have a xed priced. "Each Preferred Share was convertible at the tion of the holder at a price equal to the average closing p e of the shares of the Common Stock ... for the five ading day period preceding the date notice of conversion as given to Editek by such holder." (Compl. ¶ 12.) The C has made clear that

> a *right with a floating exercise price* is not required to be reported and will *not be deemed to be acquired* or purchased, for Section 16 purposes, until the purchase price of the underlying securities becomes fixed or established, which commonly occurs at exercise. Thus, *a right to purchase an equity security is deemed acquired as of the date the exercise or conversion price becomes fixed.*

See Exchange Act Release No. 28869, Fed. Sec. L. Rep. (CCH) "New SEC Rulings, Insider Reporting — Short Swing Trading", 2-20-91, ¶ 84,709 at 81,252 ("Exchange Act Release") (emphasis added). As the average of the preceding five days, the price of the Preferred Stock could not be determined or fixed until the date of purchase. Thus, the right referred to in the ownership provision could not be attributed to Morgan Capital until the day it converted its Preferred Stock to Common Stock: May 1, 1996. *See* SEC No Action Letter, *Realty South Investors, Inc.*, 1992 WL 139152 (S.E.C. June 17, 1992) (finding that interim price fluctuations of the common stock into which preferred stock is convertible do not implicate Section 16). On that day, Morgan Capital became a beneficial owner, and no sooner.

IV. *No Matching Short-Swing Transactions are Alleged*

Morgan Capital

As previously noted, for liability to attach under Section 16(b), a party must be a beneficial owner before the purchase occurs in a purchase-sale sequence. *See Foremost-McKesson,*

423 U.S. at 252, 96 S.Ct. at 519. For the complaint at issue to state a claim, Editek must allege that *three* transactions occurred: (1) the acquisition of securities that resulted in Morgan Capital being a beneficial owner for Section 16 purposes; *and* (2) a sale or purchase of the security; and, within six months thereafter, (3) a matching purchase or sale of the security. These three transactions are not alleged.

The Complaint alleges only that: (1) Morgan Capital converted its Preferred Stock to Common Stock, (*see* Compl. ¶ 15), which this Court has determined conveyed, for the first time, beneficial-ownership status on Morgan Capital, and (2) Morgan Capital subsequently sold a portion of its shares of Common Stock. (*See* Compl. ¶ 17.) No matching purchase is alleged. Therefore, Plaintiff's complaint has not alleged the requisite conduct which, if proven, could establish Section 16(b) liability for Morgan Capital. Simply put, Editek has accused Defendants of nothing illegal.

The Bistricers

The Complaint alleges that the Bistricers "control Morgan Capital." (Compl. ¶ 6.) All of the conduct alleged against the Bistricers is so alleged in their capacity as control persons of Morgan Capital. Because the Court has determined that the Complaint fails to allege conduct giving rise to Section 16(b) liability as to Morgan Capital, the Court also finds that the Complaint has failed to allege conduct giving rise to Section 16(b) liability on the part of the Bistricers. Accordingly, this Court will grant Defendants' Motion to Dismiss the Complaint for Failure to State a Claim Upon Which Relief Can Be Granted, as to all Defendants, and the

Court need not address the other Motions presented by Defendants.

Conclusion

Accordingly, based on the foregoing, and upon all the files, records and proceedings herein, **IT IS ORDERED** that:

(1) Defendants' Motion to Dismiss the Complaint pursuant to Rule 12(b)(6) of the Federal Rules of Civil Procedure (Doc. No. 9) is **GRANTED**; and

(2) Defendants' Motion to Dismiss the Complaint pursuant to Rule 12(b)(3) of the Federal Rules of Civil Procedure (Doc. No. 9) is **DENIED AS MOOT**; and

(3) Defendants' Motion to Dismiss the Complaint pursuant to Rule 41(b) of the Federal Rules of Civil Procedure (Doc. No. 9) is **DENIED AS MOOT**; and

(4) Plaintiff's Complaint (Doc. No. 1) is **DISMISSED WITH PREJUDICE.**

LET JUDGMENT BE ENTERED ACCORDINGLY.

APPENDIX E — RELEVANT STATUTES AND CODES

15 U.S.C. § 78p(b)
Section 16(b) of the Securities Exchange Act of 1934

§ 78p. Directors, officers, and principal stockholders

* * *

(b) Profits from purchase and sale of security within six months. For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) or a security-based swap agreement (as defined in section 206B of the Gramm-Leach-Bliley Act) involving any such equity security within any period of less than six months, unless such security or security-based swap agreement was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security or security-based swap agreement purchased or of not repurchasing the security or security-based swap agreement sold for a period exceeding six months. Suit to recover such profit may be instituted at law or in equity in any court of competent jurisdiction by the issuer, or by the owner of any security of the issuer in the name and in behalf of the issuer if the issuer shall fail or refuse to bring such suit within sixty days after request or shall fail diligently to prosecute the same thereafter; but no such suit shall be brought more than two years after the date such profit was

realized. This subsection shall not be construed to cover any transaction where such beneficial owner was not such both at the time of the purchase and sale, or the sale and purchase, of the security or security-based swap agreement (as defined in section 206B of the Gramm-Leach-Bliley Act) involved, or any transaction or transactions which the Commission by rules and regulations may exempt as not comprehended within the purpose of this subsection.

* * *

17 C.F.R. § 240.13d-3(d)(1)(i)

§ 240.13d-3 Determination of beneficial owner

* * *

(d) Notwithstanding the provisions of paragraphs (a) and (c) of this rule:

(1)(i) A person shall be deemed to be the beneficial owner of a security, subject to the provisions of paragraph (b) of this rule, if that person has the right to acquire beneficial ownership of such security, as defined in Rule 13d-3(a) (§ 240.13d-3(a)) within sixty days, including but not limited to any right to acquire: (A) Through the exercise of any option, warrant or right; (B) Through the conversion of a security; (C) Pursuant to the power to revoke a trust, discretionary account, or similar arrangement; or (D) Pursuant to the automatic termination of a trust, discretionary account or similar arrangement;

provided, however, any person who acquires a security or power specified in paragraphs (A), (B) or (C), above, with the purpose or effect of changing or influencing the control of the issuer, or in connection with or as a participant in any transaction having such purpose or effect, immediately upon such acquisition shall be deemed to be the beneficial owner of the securities which may be acquired through the exercise or conversion of such security or power. Any securities not outstanding which are subject to such options, warrants, rights or conversion privileges shall be deemed to be outstanding for the purpose of computing the percentage of outstanding securities of the class owned by such person but shall not be deemed to be outstanding for the purpose of computing the percentage of the class by any other person.

* * *

17 C.F.R. § 240.16a-1(a)(1)

§ 240.16a-1 Definition of Terms.

Terms defined in this rule shall apply solely to section 16 of the Act and the rules thereunder. These terms shall not be limited to section 16(a) of the Act but also shall apply to all other subsections under section 16 of the Act.

(a) The term *beneficial owner* shall have the following applications:

Appendix E

(1) Solely for purposes of determining whether a person is a beneficial owner of more than ten percent of any class of equity securities registered pursuant to section 12 of the Act, the term "beneficial owner" shall mean any person who is deemed a beneficial owner pursuant to section 13(d) of the Act and the rules thereunder;*provided, however,* that the following institutions or persons shall not be deemed the beneficial owner of securities of such class held for the benefit of third parties or in customer or fiduciary accounts in the ordinary course of business (or in the case of an employee benefit plan specified in paragraph (a)(1)(vi) of this section, of securities of such class allocated to plan participants where participants have voting power) as long as such shares are acquired by such institutions or persons without the purpose or effect of changing or influencing control of the issuer or engaging in any arrangement subject to Rule 13d-3(b) (§ 240.13d-3(b)):

(i) A broker or dealer registered under section 15 of the Act (15 U.S.C. 78o);

(ii) A bank as defined in section 3(a)(6) of the Act (15 U.S.C. 78c);

(iii) An insurance company as defined in section 3(a)(19) of the Act (15 U.S.C. 78c);

(iv) An investment company registered under section 8 of the Investment Company Act of 1940 (15 U.S.C. 80a-8);

(v) Any person registered as an investment adviser under Section 203 of the Investment Advisers Act of 1940 (15 U.S.C. 80b-3) or under the laws of any state;

(vi) An employee benefit plan as defined in Section 3(3) of the Employee Retirement Income Security Act of 1974, as amended, 29 U.S.C. 1001 *et seq.* ("ERISA") that is subject to the provisions of ERISA, or any such plan that is not subject to ERISA that is maintained primarily for the benefit of the employees of a state or local government or instrumentality, or an endowment fund;

(vii) A parent holding company or control person, provided the aggregate amount held directly by the parent or control person, and directly and indirectly by their subsidiaries or affiliates that are not persons specified in paragraphs (a)(1)(i) through (ix), does not exceed one percent of the securities of the subject class;

(viii) A savings association as defined in Section 3(b) of the Federal Deposit Insurance Act (12 U.S.C. 1813);

(ix) A church plan that is excluded from the definition of an investment company under section 3(c)(14) of the Investment Company Act of 1940 (15 U.S.C. 80a-3); and

(x) A group, provided that all the members are persons specified in § 240.16a-1(a)(1)(i) through (ix).

(xi) A group, provided that all the members are persons specified in § 240.16a-1(a)(1)(i) through (vii).

* * *

17 C.F.R. § 240.16a-13

§ 240.16a-13 Change in form of beneficial ownership.

A transaction, other than the exercise or conversion of a derivative security or deposit into or withdrawal from a voting trust, that effects only a change in the form of beneficial ownership without changing a person's pecuniary interest in the subject equity securities shall be exempt from section 16 of the Act.

Appendix E

17 C.F.R. § 240.16b-6(b)

§ 240.16b-6 Derivative securities.

* * *

(b) The closing of a derivative security position as a result of its exercise or conversion shall be exempt from the operation of section 16(b) of the Act, and the acquisition of underlying securities at a fixed exercise price due to the exercise or conversion of a call equivalent position or the disposition of underlying securities at a fixed exercise price due to the exercise of a put equivalent position shall be exempt from the operation of section 16(b) of the Act: *Provided, however*, That the acquisition of underlying securities from the exercise of an out-of-the-money option, warrant, or right shall not be exempt unless the exercise is necessary to comport with the sequential exercise provisions of the Internal Revenue Code (26 U.S.C. 422A).

* * * *